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JAPAN AS AN INTERNATIONAL CREDITOR: NEW ECONOMIC AND POLITICAL REALITIES

Summary

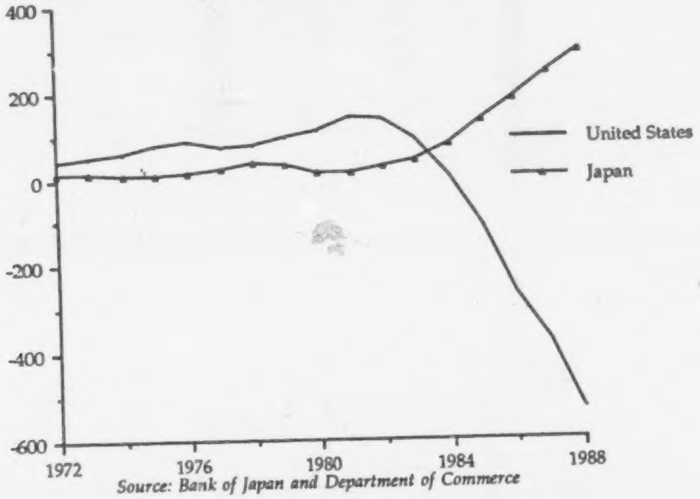
Japan is now the world's largest creditor. This means that Japan's government and Japanese firms and individuals now are owed on balance more money by nonresidents than comparable groups anywhere else in the world. The United States, which as recently as 1981 enjoyed the distinction Japan now holds, finds itself in exactly the opposite situation as the world's largest debtor. The change in the status of the two countries raises the obvious question as to whether Japan has reached its current position at the expense of the United States. While the two phenomena are related, the relationship is more complicated than one country gaining at the other's expense. Whatever the economic linkage, the political implications of this near role reversal are only beginning to be discussed on either side of the Pacific. But in this instance as well, the prospects are more complex than they appear at first glance.

Sources of Japan's International Creditor Position

As 1984 dawned the United States was a larger net creditor than Japan, but, as the Figure shows, Japan's international creditor position began climbing about that time. Many other industrial countries share Japan's status as a net creditor, even if their net position is not as large. For example, the Department of Commerce estimates that West Germany had net assets of $195 billion and the United Kingdom $150 billion in 1988, making their combined worldwide position larger than that of Japan for which the comparable figure was $292 billion. Similarly, the net assets of Western Europe in the United States last year were more than three times as large as Japan's $129 billion. Moreover,

Net International Investment Positions

(in billions of dollars at yearend)



Source: Bank of Japan and Department of Commerce

the figures for the United States probably understate the true value of U.S. foreign assets, including gold, and therefore are too pessimistic concerning the extent of the U.S. debtor position. However, they most likely correctly represent the decline in the U.S. net position.[1]

Just as the international debtor position of the United States grows out of its domestic economy, so does Japan's role as the largest international creditor. In Japan, as elsewhere, households, government and business are all potential users and suppliers of funds in the form of savings. By definition, sources of funds equal uses of funds. If, as has been the case with Japan in recent years, domestic uses are less than domestic sources, the extra savings are represented (except for a small statistical discrepancy) by the flow of funds abroad. Conversely, if domestic savings are less than the uses of funds, as has been true of the United States in recent years, the country experiences a capital inflow. Countries with an outflow over many years, such as Japan, eventually develop large international creditor positions, while countries like the United States become large debtors.

Trade deficits and surpluses are another way of describing the same phenomenon. Nations engaging in international trade have to settle the imbalance in some way. One way, analogous to a consumer running up charges on a credit card, is to go into debt, which the borrower eventually may have to repay. Nationals of one country, once induced to accept the currency of another in payment, in effect agree to accept an IOU they later can use to purchase the goods of the debtor country. That is, net changes in the level of IOUs and other borrowing exactly equal the trade imbalance of a given country over a specific period.

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[1] For details of this argument, see Sarah A. Hooker, The International Investment Position of the United States (Washington, D.C.: National Defense Research Institute, October 1988).

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Thus, while net borrowing equals the trade imbalance, it also, as indicated earlier, equals surplus savings. Therefore, the international flow of funds, the current account balance and the surplus or shortfall of savings are three ways of representing the same phenomenon.

While these concepts are inextricably linked, experts disagree about what causes what. The arithmetic relationship tells us nothing about whether trade imbalances create savings imbalances or whether it is the other way around. However, many experts believe that the government's net demand for funds is an identifiable independent factor in the equation. As such, increases in the budget deficit in the United States, for example, deserve serious consideration as causal factors for the trade imbalance and the corresponding capital inflow into the United States. Similarly, most economists believe that Japan's high personal savings rate is more of a cause than an effect of the other factors in the equation. However, unlike the U.S. budget deficit, the Japanese savings rate changes relatively little year by year. Thus, the budget deficit is a leading candidate to explain the explosion during the early 1980s of the U.S. current account deficit and its probable persistence into the 1990s.

Table 1 gives some indication of how these factors have evolved for three of the largest trading countries -- the United States, Japan and West Germany. By broad measures of government spending in 1979 the United States had a small budget surplus and virtual balance in its current account. Japan

Table 1: Current Account and Government and Private Domestic Imbalances

(percent of GNP)

	1979	1982	1985	1987	1988
Japan					
Current Account	-0.9%	0.6%	3.7%	3.6%	2.8%
Fiscal Balance*	-4.7	-3.6	-0.8	0.6	1.3
Private Net Savings**	3.8	4.2	4.5	3.0	1.5
United States					
Current Account	0.0	-0.3	-2.9	-3.4	-2.8
Fiscal Balance*	0.5	-3.5	-3.3	-2.3	-1.8
Private Net Savings**	-0.5	3.2	0.4	-1.1	-1.0
West Germany					
Current Account	-0.7	0.8	2.6	4.0	4.0
Fiscal Balance*	-2.6	-3.3	-1.1	-1.8	-2.0
Private Net Savings**	1.9	4.1	3.7	5.8	6.0

*Central and local governments.
**Gross savings in business and household sectors minus gross investment in business and household sectors.

Source: Bank for International Settlements and West Germany, by contrast, had budget and balance of payment deficits. In the early 1980s the U.S. budget deficit turned sharply negative, with corresponding changes in the current account. Tokyo and, to a lesser extent, Bonn reduced their budget deficits, and the two countries moved to large surpluses in their trade accounts. Since 1987 the trade account in Japan has declined as a percentage of gross national product despite continuing progress in reining in government spending, while the imbalance rose in West Germany between 1982 and 1987 and stayed at 1987 levels last year.

Another interpretation of Table 1 is that Japan's international creditor position grew rapidly in the mid-1980s but is now rising more slowly, at least temporarily, as measured in yen relative to the domestic Japanese economy. However, Japan's economy continues to grow rapidly and, at least between late 1985 and 1987, its currency appreciated; both economic growth and the yen's appreciation tended to inflate the dollar-denominated capital outflow. For these reasons, the growth in Japan's international creditor position looms large relative to the U.S. economy, even while it appears to be shrinking relative to the Japanese economy.

Table 2 gives some details of how Japanese sectoral financial demands contributed to the relatively smaller capital outflows from Japan in 1987 and 1988. As Japanese experts have been at pains to explain to American audiences, the answer is domestic demand. Surging plant and equipment spending by corporations, coupled with healthy housing expenditures by consumers, widened the deficit of funds in the corporate sector and reduced excess savings by households, more than offsetting the diminishing demand from the public sector. (In Table 2 the rest of the world sector corresponds approximately to Japan's current account but with the signs reversed. It shows a negative balance because this sector is a net user of funds provided by domestic sectors.)

As a result of these flows, the United States and Japan find themselves in opposite situations regarding the relationship between expenditures and pro-

Table 2: Financial Surpluses and Deficits in Japan by Sector

(in trillions of yen)

	1981	1982	1983	1984	1985	1986	1987	1988
Incorporated Businesses	-Y7.8	-Y10.3	-Y8.5	-Y5.1	-Y6.0	-Y4.3	-Y7.7	-Y16.9
Households	28.1	29.0	29.0	29.3	31.1	33.8	27.3	27.8
Public	-18.7	-18.6	-19.0	-17.3	-13.2	-13.8	-4.8	2.2
Financial	-0.5	1.7	3.5	1.5	-0.5	-1.5	-2.3	-2.8
Rest of World	-1.1	-1.8	-5.0	-8.3	-11.5	-14.2	-12.5	-10.2

Source: Bank of Japan

duction. The United States like any deficit country creates a potential future international liability for itself. As such, Americans now enjoy high present levels of expenditures at the cost of future living standards, other things being equal. However, if the United States manages to use the borrowed funds for greater capital spending and other investment than otherwise would be possible, it may be able to increase its productive capacity enough to avoid a long-run drop in living standards as the bills come due.

Conversely, if Japan -- because of trade restraints, exchange rate manipulation or high savings -- manages to run a chronic trade surplus, in effect it acts in support of extraordinary expenditures among its trading partners at the cost of its own living standards. In the long run it can hope to be repaid, with interest. For Japan, which is concerned about its rapidly aging population, current account surpluses in the late 1980s may be a way of preparing for a reverse flow early in the next century when productive capacity may be much lower relative to consumer demand than it is today.

Causes of Japan's International Capital Flow

As indicated above, most experts believe that America's federal budget deficit has played a major role in creating an inflow of capital to the United States. As Washington's demand for funds grew in the 1980s, interest rates rose from the levels they otherwise would have reached, attracting more foreign funds to this country. Money was pulled into the United States from all over the world, not just Japan, as evidenced by the current account deficits the United States has had in the late 1980s with Western Europe, Latin America and Asian countries other than Japan.

But if the budget deficit here exerted a mighty pull, factors in Japan combined to push the funds out. One already mentioned was high savings. At least during the postwar period, household savings rates in Japan have been among the world's highest. The rise in the U.S. budget deficit coincided with factors that made it likely that this savings pool would be mobilized in the financing of the U.S. budget deficit, directly or indirectly. As noted above, the demand for savings in Japan was increasing only slowly since government budget deficits were on the decline and the needs of the corporate sector were modest, at least until recently. Thus, the supply of savings increased as the savings rate held relatively steady and the economy grew.

At the same time, investing overseas became easier. Changes in Japan's Foreign Exchange and Foreign Trade Control Law in 1980 made unrestricted international capital flows the rule rather than the exception, which most, but not all, observers believe enhanced the attractiveness of investment abroad. The pace of change has accelerated in recent years. Changes in provisions since 1984 relating to outbound capital flows include the following:

- In April 1984 the "real demand rule" that required substantiation of the need for a forward exchange transaction was removed, yen-denominated loans to nonresidents were liberalized and the guidelines and qualification standards for samurai bonds were relaxed, among other changes. (Samurai bonds are a way for foreign firms to raise money in the Japanese market and, therefore, a means of facilitating outbound capital flows.)

- In December 1984 and again in April 1985 guidelines and qualification standards for Eurobond issues by nonresidents were relaxed.

- In April 1985 Euroyen loans with maturities over one year for nonresidents were liberalized.

- In April 1986 Euroyen certificate of deposit maturities were lengthened and the credit rating system for Eurobonds was upgraded.

- In June 1986 foreign banks received permission to issue Eurobonds.

- In November 1987 Euroyen commercial paper issues were permitted for nonresidents. Guidelines for issuing Euroyen and domestic commercial paper by nonresidents of Japan were relaxed in December 1988.

All these changes had the effect of making it easier for Japanese savings to meet the overseas demand for funds, often in the Euromarkets of London and elsewhere where regulations were minimal, operating costs low and spreads thin -- a vast difference from the days prior to 1971 when Japanese individuals and institutions could not buy non-Japanese securities denominated in a currency other than yen.[2]

Changes in the Foreign Exchange and Foreign Trade Control Law and other liberalization measures generally made it easier for non-Japanese to invest in Japan as well as for Japanese to invest outside Japan. For Japanese corporations these changes meant they now had much more freedom than previously to raise funds on international capital markets to finance their activities in Japan or elsewhere. Japanese firms have responded enthusiastically to this opportunity. For example, between April and September of this year they reportedly raised as much as half their funds in the Eurobond and other offshore bond markets (see JEI Report No. 41B, October 27, 1989).

To the extent that the liability side of their balance sheet is in overseas currencies, Japanese firms may want to avoid currency risks by diversifying their assets out of yen as well, giving overseas activity still another push. As Japanese banks and securities companies have set up offices abroad and increasingly participate in London and New York financial markets, individual and institutional investors have gained additional channels for investing overseas, whether or not the original purpose of the banks or brokerage houses was mainly to facilitate capital flows from Japan.

In sum, during recent years regulations have been relaxed continually, making investment abroad much easier for Japanese firms and individuals, primarily by widening the choice of vehicles that can be used. But the response of institutional and corporate investors to deregulation has been relatively subdued in some instances. As large players Japanese banks and insurance companies may not want to risk disruption of international markets should they suddenly enter at the permitted level. For example, after 1986 the Finance Ministry allowed Japanese insurance companies to invest 30 percent of their assets overseas, up from 25 percent previously and 10 percent less than two years earlier. However, while the growth in foreign assets has been rapid since 1986, insurance companies appear to be well under even the 25 percent figure that was permitted immediately prior to the 1986 liberalization. In some instances, of course, deregulation has advanced to the point where the remaining rules are no longer binding; Japanese firms simply may not want to invest as much abroad as the government allows.

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[2] Yoshio Terasawa, "Comment on 'Opening Japanese Financial Markets: What Has Changed, What Will Change'" in Thomas A. Pugel (ed.), Fragile Interdependence (Lexington, Massachusetts: Lexington Books, 1986), p. 138.

Components of Japan's Foreign Assets and Liabilities

The regulatory changes affecting foreign capital flows imply that the composition of Japan's foreign assets and liabilities probably has changed. That, in fact, has been the case, as shown in Tables 3 and 4. The government accounted for most of the net position in the 1970s, in part a consequence of still restricted private capital flows. In recent years private investment has played a greater role.

Table 3: Japan's Net External Assets

(in millions of dollars)

End of Year	Private Sector	Government Sector	Total
1972	$-6,820	$20,687	$13,867
1973	-3,021	16,037	13,016
1974	-8,318	17,261	8,943
1975	-10,302	17,320	7,018
1976	-11,653	21,227	9,574
1977	-6,182	28,162	21,980
1978	-2,550	38,764	36,214
1979	850	27,927	28,777
1980	-16,659	28,193	11,534
1981	-18,537	29,455	10,918
1982	2,046	22,636	24,682
1983	11,928	25,331	37,259
1984	47,069	27,277	74,346
1985	104,450	25,371	129,821
1986	138,541	41,810	180,351
1987	146,494	94,250	240,744
1988	147,571	144,175	291,746

Source: Bank of Japan, Balance of Payments Monthly, April 1989.

A striking characteristic of the 1988 data is the surge in short-term private borrowing by Japanese banks (represented in Table 4 as short-term private monetary movements), which widened the already enormous private net short-term liability position. Japanese banks and other firms have increased their short-term borrowing in the Euromarket and elsewhere. As a result, private net assets hardly increased in 1988 (Table 3), despite the continued growth of long-term private assets, such as securities and direct investment, the two most publicly discussed dimensions of Japan's overseas net asset position. The government boosted its net asset position dramatically by lending to developing countries and increasing its foreign reserves, which account for the bulk of short-term government monetary movements in Table 4.

Table 4: Japan's External Assets and Liabilities

(in millions of dollars)

	Assets		Liabilities	
	End of 1987	End of 1988	End of 1987	End of 1988
Long-Term	$646,181	$832,669	$236,181	$311,625
Private Sector	565,100	728,168	178,810	268,431
Direct Investments	77,022	110,780	9,018	10,416
Trade Credits	37,189	48,791	35	23
Loans	97,469	123,663	1,101	1,061
Securities	339,677	427,218	166,206	254,886
Others	13,743	17,716	2,450	2,045
Government Sector	81,081	104,501	57,371	43,194
Loans	43,145	55,570	47	26
Others	37,936	48,931	57,324	43,168
Short-Term	425,450	636,678	594,706	865,976
Private Sector	343,261	538,802	583,057	850,968
Monetary Movements	320,171	502,256	530,072	765,165
Others	23,090	36,546	52,985	85,803
Government Sector	82,189	97,876	11,649	15,008
Monetary Movements	82,175	97,869	3,922	5,144
Others	14	7	7,727	9,864
Total	1,071,631	1,469,347	830,887	1,177,601

Source: Bank of Japan, Balance of Payments Monthly, April 1989.

Japan's Role as an Owner of Assets in the United States

Not surprisingly, Japan accounts for a significant portion of this country's net international indebtedness. Table 5, based on U.S. data and therefore not comparable to Tables 3 and 4, shows this result. (The Bank of Japan does not publish comparable data.) Japan's assets in the United States have topped U.S. assets in that country since 1983, but its percentage of the U.S. net debtor position peaked in 1985. At the same time the net figures hide the very substantial increase in U.S. assets in Japan. Between 1981 and 1988 the number more than tripled, jumping from $43 billion to $156.3 billion. Most U.S. assets in Japan are interbank claims resulting from, for example, the transfer of funds by a U.S. bank to its office in Tokyo.

For policymakers a key question is the extent to which these assets in the United States and Japan are potentially "footloose" and liable to be withdrawn on short notice. While the data suggest that this concern could be bilateral, the principal fear seems to be among Americans that Japanese investors will withdraw funds from the United States, throwing a supply of dollars onto world currency markets with disastrous consequences for the value of the American currency and for U.S. interest rates, which would rise.

Unfortunately, neither the Commerce Department nor the Bank of Japan publishes data on what is arguably one of the most volatile dimensions of

Table 5: U.S. Net Asset Position with Japan

(in billions of dollars)

	Japanese Assets in the United States	U.S. Assets in Japan	Net U.S. Position with Japan	Overall Net U.S. Position
1973	$14.3	$12.3	$-2.0	$47.9
1974	16.8	18.9	2.0	58.7
1975	16.4	17.4	0.9	74.2
1976	20.4	18.2	-2.1	83.6
1977	26.5	17.7	-8.8	72.7
1978	39.9	23.5	-16.5	76.1
1979	28.0	29.4	1.4	94.5
1980	35.3	37.4	2.1	106.3
1981	44.7	43.0	-1.7	140.9
1982	43.4	44.8	1.4	136.7
1983	50.1	48.4	-1.7	89.0
1984	67.6	48.3	-19.3	3.3
1985	101.1	56.1	-45.0	-111.4
1986	156.2	91.9	-64.3	-267.8
1987	197.7	113.4	-84.3	-378.3
1988	284.8	156.3	-128.5	-532.5

Source: Department of Commerce

Japanese investment in the United States, the purchase of Treasury bills and other short-term instruments. Note, however, that Japan's net worldwide position in private short-term instruments is negative (Table 4), suggesting that any concerns involving short-term instruments really should be bilateral.

Table 6 shows Bank of Japan data for the flow of long-term funds of various kinds into the U.S. market. Japanese long-term investment of all kinds in the United States has shown explosive growth. But direct investment -- where the foreign investor is considered an owner -- has grown more rapidly than portfolio investment, where the overseas investor takes a more passive, and potentially footloose, position in a company's stocks or bonds or long-term U.S. government securities. Based on the cumulative effect of the flows shown in Table 6, however, the stock of portfolio investment probably is still far larger than the comparable figure for Japanese direct investment.

The published Japanese data do not break down investment in the United States by stocks, bonds and government securities. Department of the Treasury data, which include purchases of marketable Treasury notes and bonds by foreign governments, show tremendous year-to-year variation in the pattern of Japanese purchases between 1985 and the first six months of 1989. For example, Japanese investors bought a mere net $300 million in U.S. stocks in 1985, but $3.3 billion the following year and $11.4 billion in 1987. Presumably reflecting hesitancy after the stock market crash in October 1987, net purchases dropped to $1.9 billion in 1988 and only $400 million during the first six months of this year. Treasury bonds and notes varied from an astounding 76 percent of total Japanese investment in long-term securities in 1985 to a negligible percentage

Table 6: Japan's Long-Term Capital Outflows to the United States

(in billions of dollars)

	Direct Investment	Trade Credits	Loans	Securities	Other	Total
1978	$0.8	$0.0	$0.0	$1.5	$0.3	$2.6
1979	0.9	0.0	0.6	0.6	0.0	2.2
1980	0.8	0.0	0.3	-1.6	0.0	-0.3
1981	1.9	0.0	0.2	1.5	0.4	4.1
1982	1.6	0.8	0.1	0.6	0.5	3.6
1983	1.3	0.2	0.3	5.0	0.2	7.1
1984	3.1	0.2	0.4	11.3	0.4	15.4
1985	2.5	0.6	0.7	31.6	0.0	35.4
1986	8.0	0.3	0.6	49.4	0.9	59.2
1987	9.6	0.5	1.5	37.4	1.6	50.6
1988	19.0	1.0	2.8	36.2	2.5	61.5

Source: Bank of Japan

the following year before rebounding to intermediate levels in the most recent years.

The year-to-year variation in Japanese investment does raise questions, of course, but all investors, foreign and domestic, move into and out of markets with increasing frequency. As comparatively small players in U.S. equity and corporate bond markets (Western Europe, for example, outnumbers Japan by a 5-1 margin in holdings of U.S. equities), Japanese investors' potential threat in these securities markets would appear relatively small. And, at least during the critical period immediately following the 1987 stock market crash, Japanese investors apparently were more patient than some others. The Treasury data show that between October and December 1987, foreign investors pulled a net $7.2 billion off Wall Street, led by the United Kingdom, which accounted for $5 billion of the total. But Japanese investors added $1.9 billion to their holdings, the only large group of international investors to take this action. (This move, by the way, proves that the majority is not always right. The subsequent run-up of the dollar and the recovery of the stock market suggest the Japanese action was a profitable one, especially if the investors cashed in some time in mid-1989.)

Taken together, the Japanese and the U.S. data imply that the role of Japanese funds in the United States has increased tremendously in recent years. That, in turn, suggests increased Japanese influence over the U.S. financial system. But that influence is still remarkably small. Even with the rapid increase in Japanese investment in America, Japanese and other foreign investors own a relatively small part of U.S. financial assets, where their holdings are still mainly concentrated. According to Federal Reserve Board data that do not break out ownership by country, foreign investors owned 5.7 percent of all U.S. financial assets in 1986, up from 4 percent five years earlier. The increase largely was accounted for by the run-up in the U.S. federal debt, which more than doubled in size during the period. However, foreign investors held 14.8 percent of all Treasury securities, which actually was down from 17.1 percent in 1981.

For some of the Federal Reserve Board categories, the Commerce Department provides a breakout by country. Overall, Japan claimed 15.9 percent of foreign assets in this country in 1988, but for some types of assets the figure was far lower. Japan's share of foreign-owned stock came to only 9.4 percent, suggesting that, since foreign investors account for approximately 5 percent of the total, under one-half of 1 percent of U.S. stock is held by Japanese investors.

Many casual observers of the real estate market, especially in some of America's largest cities, would suggest that this industry is an exception to the pattern of relatively low Japanese investment. While the data are sketchy, that apparently is not the case. The National Association of Realtors, a private group, estimated in 1989 that, as of 1986, only 1.5 percent of all U.S. commercial real estate and an even smaller 1 percent of farmland, was in foreign hands. Commerce Department data suggest that no more than 31 percent of foreign-owned property is Japanese, suggesting that Japanese ownership of real estate -- probably less than half a percent -- is about the same as it is of U.S. stocks.

Japan's Net Creditor Position and its Role in the World Economy

While the position of Japanese investors in the United States is important, ultimately the significance of Japan being a net international creditor is likely to lie in the ways in which it has already reshaped and will continue to alter the world financial system. Fundamentally, Japan's position as a net creditor means that the Japanese government and corporations are in the position of lending money to the rest of the world, either by buying Treasury securities in the United States or Eurobonds in London issued by nations or firms almost everywhere, lending money to refinance Third World debt or in other ways. While the United States and other countries may have net capital flows to some other parts of the world, Japan's net creditor position, assuming it continues, means that Japan will be the leading financier in more cases than not.

The demand for capital around the world is great. The huge U.S. budget deficit has been mentioned. In terms of the effect on the borrowing economy, however, Japanese international lending may be most important in Third World countries like Brazil and Mexico. In many respects the emergence of Japan as such a large net creditor is fortunate for these countries even though outstanding Japanese bank and official loans to the Third World are still modest compared with those from Washington and from American banks. With the United States absorbing a high proportion of international capital flows, interest rates throughout the world are somewhat higher than they would be otherwise, making the problems of Third World countries all the more desperate. Japan's ability to provide funds has had a countervailing effect on international interest rates, whether or not the Japanese government or Japanese banks actually extend funds to less developed countries. In this sense, the United States has been among the bad boys of international finance and Japan a good boy.

Historically, net lenders bring to the international financial system two players: their banks and their currency. In Japan's case the first has clearly arrived and the second may be on its way. Creditors obviously want to monitor their lending carefully and for that reason want to be close to it. Partly for this reason, Americans should not be surprised to see not only Japanese banks but Japanese brokerage houses and insurance companies at the heart of the action in U.S. financial markets.

The relationship between a large creditor position and the international use of the yen is a little more complicated. In many respects the postwar international economic system has been set up with the dollar as the centerpiece. Given the convenience of a single currency for denominating international transactions, for example, the dollar has maintained its position despite the relative decline of the United States in other respects. But a larger role for the yen is virtually inevitable. Japanese international investors, for example, want protection from currency fluctuations since their stockholders or policyholders expect their returns in yen. Japanese life insurance companies, which took a bath on their dollar-denominated assets when the dollar plummeted, are a case in point. This suggests a likely increase in short- and long-term securities that are tied to the yen.

Full internationalization of the yen would involve much more than yen-denominated bonds or other lending. The pros and cons of such measures as yen-denominated foreign currency reserves, however, would take the discussion far beyond this examination of Japan's role as an international creditor.

Japan in a Multipolar Economic World

Even if the dollar should remain the principal world currency, Japan's continued role as an international creditor raises questions about world economic leadership in financial markets. In the postwar period the United States clearly has played that role. Many experts believe that Japan is working behind-the-scenes to increase its influence. For example, some analysts speculate that Tokyo would like a Japanese national to be the next managing director of the International Monetary Fund, a post that traditionally has gone to a European. (An American traditionally heads the IMF's sister institution, the World Bank.) The term of the current IMF managing director, Michel Camdessus of France, expires in January 1992. Such a move would not directly threaten American preeminence, but can Tokyo gain influence without pushing the United States aside and still have a workable international financial system? Yes, but shared leadership has its own dangers.

The world economic system can be compared to a a hazardous waterway with a publicly financed coast guard providing emergency services. When major banks or other financial institutions navigating this waterway find themselves in a particularly dangerous section that jeopardizes both themselves and the stability of the international financial system, the coast guard does its work. In the past the Department of the Treasury has coordinated such rescue operations even when relatively little U.S. government money was at stake. Washington has been willing to play this role for multiple reasons: the banks or other threatened institutions have been largely American, the financial system -- not just individual banks -- has been believed to be at risk and the crisis often has involved countries with strategic political importance for this country. In addition, the solutions often have involved leaning on American financial institutions for help.

The Third World debt problem, which first received public recognition in 1982, provides one example. The situation has reached crisis proportions when banks have appeared to be at risk if they did not get prompt payment from their Third World borrowers. But Washington also believes the interest burden of the debt has posed a threat to economies in the Third World, which in turn affects U.S. political and military interests. Solutions, at least until recently, often have involved additional lending. The Treasury and bank committees dominated by U.S. banks have been the leaders in cobbling together solutions, even in 1989 after a Japanese initiative, associated with former Finance Minister Kiichi Miyazawa, on Third World debt appeared to be giving Tokyo and Japanese banks a higher profile.

Compare this situation to one where the lending banks are mostly Japanese and European. The value of providing "coast guard" services is no longer so obvious to Washington. But Tokyo and others may not have an overwhelming reason to replace Washington in that role if, as would be likely, their banks and politicians have merely a fraction of the economic, strategic and political interests that have been crucial to America's motivations. Nor would having multiple "coast guards" make much sense. Diversified efforts could result in too many boats swamping the rescue if efforts were not carefully coordinated, and coordination might prove impossible in an emergency.

The global stock market collapse in October 1987 provides another example, relating to both causes and the responses to it. While theories abound about why stock prices tumbled around the world, one argument has to do with higher European interest rates sending a scare through Wall Street, in part because the new rates were seen as undermining economic policy coordination among the Group of Seven industrial countries. In short, the multiple, coordinated coast guard action was regarded as a failure. But, in at least one respect, Washington did come to the rescue, at least domestically after the crash, by providing liquidity to U.S. financial firms that faced large withdrawals. This action has been seen as instrumental in preventing a worse disaster. Many U.S. analysts credit the Ministry of Finance with an effective rescue of the Tokyo market, which also crashed.

Despite increasing participation from abroad, the stock markets in Japan and the United States still are dominated by domestic institutions and investors. However, equity and other financial markets are expected to become much more international in all dimensions in coming years, suggesting that the types of rescues effected in New York and Tokyo in 1987 may have been a last hurrah of sorts for national actions affecting primarily domestically owned financial institutions. Would the rescue on Wall Street have been as swift if the investors had been more mixed? What if many of the major banks pressed into service as part of the rescue team by the Federal Reserve Board and the Treasury had been Japanese- and European-owned? A more diversified group of investors may have diluted the interest of all concerned in responding to or orchestrating a rescue -- depending on the degree of self- or national interest that was involved.

The stock market example illustrates the need for new thinking on the role of global financial leadership. However, the debt crisis example suggests that like many other public services (police, fire protection, airplane traffic control) international financial coordination functions best when each of those receiving benefits is somehow convinced to make a contribution, financial or otherwise, in support of an established leader. In actions involving worldwide financial interests that leader in the past 40 years or so has been the United States. Such a system is likely to continue and to be viable provided each participant can see the benefit to itself and is generous enough to make a commensurate contribution when asked. Continued success depends on each contributor being committed to preserving the financial system. In addition, in a system where the economic, political and strategic forces are not propelled by any one nation, only a leader that understands and accepts the needs of each of the participants will receive continued support.

This may be the evolving system. By virtue of experience, if nothing else, the United States has continued to play the role of "coast guard" in Third World debt issues and other international financial emergencies. But, as witnessed by Japan's unique financial contribution toward the hoped-for success of the Brady Plan, named predictably enough after the current treasury secretary, other countries -- including Japan -- play important roles in helping to make the rescues financially and politically viable. For its part, if Washington is to be the commandant of this global coast guard, it will have to be alert to the interests of each of the parties. In particular, it will have to recognize that Tokyo's priorities will sometimes conflict with its own, and it must be willing to subordinate its own interests. An effort to establish a system based on "Japanese money, U.S. control" is certain to lead to a non-American commandant and is most likely doomed to failure if the new leadership lacks the necessary international perspective.

Some analysts believe that Tokyo does not really relish global economic leadership. R. Taggart Murphy, a managing director of an American bank subsidiary in Tokyo and an affiliate of the U.S.-Japan Relations Program at Harvard University, is among those who see Japan as unsuited and unwilling to play a leading role. He writes:

> For all of its success at managing its own economy, however, Japan lacks the ideology and political commitment necessary to fulfill the obligations that go with financial power. To turn sheer financial strength into leadership, a country must be able to think in global terms, to view itself as a world central banker, to sacrifice certain short-term gains to maintain stable financial and trading systems. Japan does not have this world view. It holds the rest of the world at arm's length, and that separateness prevents Japan from assuming some of the important mandates of world financial leadership.[3]

Other Japanese and American analysts might question Taggart's implicit argument that Japan cannot grow into a new political role, just as it has economically. Taggart simply may be describing the reality that Japan still does not have as much at stake as the United States traditionally has had in world financial markets. If so, the kind of "coast guard commandant role" outlined above for the United States would be appropriate.

Conclusion

Japan's emergence as the world's largest international creditor has not yet brought in its wake profound political or economic change to the world financial system. Some such recalibration of that system, though, already has occurred and is likely to continue.

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[3] R. Taggart Murphy, "Power Without Purpose: The Crisis of Japan's Global Financial Dominance," Harvard Business Review (March-April 1989), p. 74.

For Americans and those living in Third World countries, Japan's position is something of a godsend, relieving unwanted pressures on interest rates and living standards. In addition, Japanese investment in the United States may permit a larger increase in capital spending in this country than otherwise would be possible, thereby enhancing the competitiveness of American firms compared to Japanese companies and other rivals overseas. The immediate price for Americans is that Japanese and other foreign investors own a slightly larger part of the U.S. economy than they did before. In addition, potentially "footloose" inbound and outbound capital flows involving Japan raise new questions about the stability of exchange rates and international financial markets.

Some analysts believe Japanese firms will be motivated to repatriate at least a portion of their foreign investments early in the next century, if not sooner, in response to the rising needs in Japan of an aging population. Japanese and other investors have a right, of course, to repatriate their profits and even their original investments to their home country. Should this happen, U.S. living standards would have to fall for exports to rise unless total production simultaneously increased here. Given the small percentage of foreign ownership in this country, such a reduction in living standards probably would be modest. However, mounting U.S. debt increases the eventual cost of this adjustment every year.

For further information, contact Douglas Ostrom.

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The views expressed in this report are those of the author and do not necessarily represent those of the Japan Economic Institute.

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JEI

REPORT

A Two-Part Report: A and B

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IN THIS ISSUE:

Uruguay Round Enters New Phase 1

IMF, GATT See Healthy World Trade
And Financial Flows In 1988 3

Japan Expands Aid To Eastern Europe 4

Congressional Measures Target
Foreign-Owned Companies 7

Notes: Opposition Tax Bills;
Manufactured Imports;
Semiconductors 9

Uruguay Round Enters New Phase

Multilateral trade negotiations are at a stage where the harvest will have to be collected soon. But many are hoping that new proposals -- some not yet submitted -- still will have time to blossom into agreements. However, some consider the recent response from the European Community to a U.S. farm proposal suggestive of a wintry blast. These ongoing negotiations under the General Agreement on Tariffs and Trade began in 1986 and are scheduled for completion in December 1990. Dubbed the Uruguay Round, they have been described as the most ambitious of the rounds held periodically since World War II, but during the past three years they sometimes have appeared to be on the verge of collapse. (For an overview of the Uruguay Round and previous rounds, see JEI Report No. 25A, June 30, 1989).

In late October Washington presented its plans on agriculture and services, two of the 15 sectors under discussion, to the respective GATT negotiating groups then reconvening in Geneva. Most of the attention centered on agriculture, the sector that had been responsible for much of the tumult in review sessions last December in Montreal and again this April in Geneva (see JEI higher than its overall industrial country-average forecast of 3.5 percent. The IMF expects Japan's current account imbalance to creep downward to $72 billion in 1989 from $79.6 billion in 1988. The news will worsen in 1990, however. Although the IMF projects that real Japanese growth will reach 4 percent, exceeding the industrial-country average of 2.9 percent, the world monetary body also expects Japan's current account imbalance to widen to $90 billion, reflecting, in part, the weakness of the yen through much of 1989.

The IMF's proposed tonic for the 1990s is an alternative that many Americans have tired of hearing: cutting the U.S. budget deficit. Among its various scenarios ranging from no response -- and an eventual loss of nerve among foreign investors in the U.S. economy -- to a cut in the U.S. red ink in line with budget-reduction targets under the Gramm-Rudman-Hollings act, the IMF finds that the latter course would have several important effects. These include somewhat slower growth for Japan and other American trading partners and commensurate benefits in terms of the value of the dollar and interest rates, a particular concern for heavily indebted developing countries. Both Japan and West Germany would experience significant and lasting reductions in their current account surpluses.

If the IMF report sketches possible pitfalls during the next year or so and how to avoid them, the GATT study lays out what could be. It points out that world trade is growing twice as fast as output, with growth concentrated in manufactured goods and, within that sector, capital goods. Both the United States and Japan experienced a rapid expansion in imports of capital goods during 1988. In Japan capital goods imports grew twice as fast as business investment, which itself expanded at a fast pace. In the United States capital goods accounted for half of export growth and almost two-thirds of import growth between 1986 and 1988.

Capital goods are one of the basic building blocks of higher productivity. Their importance in the current worldwide economic expansion raises the prospect of a virtuous cycle, with rising productivity in the United States, Japan and elsewhere creating both new supplies and demands for traded goods. GATT economists are quick to join their IMF counterparts in adding that such a favorable scenario by no means is guaranteed. Macroeconomic imbalances and periodic sectoral overinvestment are just two examples of problems that will remain, GATT warns. Even so, GATT hints that the late 1980s and the early 1990s are coming to resemble the 1950s and the early 1960s -- which some free traders regard as just short of a golden age for international commerce, especially when compared to the troubled late 1960s and the 1970s. For Japan, a major beneficiary of the earlier climate and today among the world's leading traders, this prognosis is very good news indeed.

Douglas Ostrom

Japan Expands Aid To Eastern Europe

Recognizing the important political changes that have occurred in certain Eastern European countries during the past year, Japan pledged October 21 to provide greater economic assistance to Poland and Hungary, two countries considered by Tokyo to be the most "reformist" in the region. These initiatives are in line with Prime Minister Toshiki Kaifu's plan to become more active diplomatically after his Diet election October 31 to a full, two-year term as prime minister, according to Foreign Minister Taro Nakayama. However, Japan's increased responsiveness to the economic needs of the Soviet bloc countries may represent yet another aspect of Tokyo's ongoing effort to assume greater responsibility for the world's trade and development problems.

In anticipation of a late November meeting in Brussels of the major Western industrial nations on the economic crisis in Eastern Europe, Tokyo reportedly has adopted a set of measures aimed at supporting the economic reforms launched in Poland and Hungary. According to Japanese government sources, the new policy calls for active participation in a $643 million assistance plan proposed by the European Community, under which the EC has pledged to provide approximately $321 million and the United States about $126 million. Tokyo has not yet said how much money it would contribute to this effort. The Foreign Ministry in early October formed a special working group to develop economic assistance proposals with special attention to Poland's food shortage. Given the seriousness of this problem, Mr. Nakayama indicated that Tokyo may offer Warsaw emergency food aid before a more comprehensive aid package is proposed.

Mr. Kaifu told the House of Councillors Budget Committee October 24 that he is studying the possibility of visiting Eastern Europe in early January as one leg of an overseas trip that also would take him to various Western European countries. Mr. Nakayama the day before was reported to have strongly encouraged the prime minister to visit Hungary and Poland, in particular, as soon as possible. This type of high-level diplomatic contact would "clearly elucidate [Japan's] position toward reformist countries in the region," the foreign minister reportedly stated.

In negotiations in Warsaw October 25 Tokyo agreed to reschedule Y56.3 billion ($402.1 million at Y140=$1.00) worth of official debt incurred by Poland. About Y48 billion ($342.9 million) of this total reflects export insurance paid out by the Japanese government to cover Poland's past failure to pay for imports from Japan. Another Y8.5 billion ($60.7 million) represents loans extended by the Export-Import Bank of Japan. The agreement calls for Warsaw to repay the principal and interest over five years after a five-year grace period. Japan apparently was the last of Poland's creditor nations to reach an agreement on debt rescheduling. Jan Majewski, Polish deputy foreign minister, is expected to review this and other aspects of Japan's assistance to his country on his November 4-9 Tokyo visit.

The Japanese government also reportedly is considering ways to extend help outside the rubric of its official development assistance program. The Ministry of Foreign Affairs, which is the lead agency for Japan's foreign aid programs, has responded that while there is increasing awareness of the magnitude of the needs in Poland and Hungary, Tokyo has not yet decided whether or to what extent it should exceed the parameters of the ODA program. However, the government has indicated it intends to increase activities generally designed to promote friendly ties with Warsaw Pact countries, such as sending environmental missions there and holding seminars to promote economic relations with them.

Poland and Hungary are not the only Eastern European countries clamoring for Japanese aid. During his October 26 meeting with Mr. Kaifu, Bulgarian deputy prime minister Petko Danchev was not in the least bit reserved in encouraging greater Japanese investment in his country. Mr. Danchev told the prime minister that Bulgaria is implementing various economic reforms, some of which are designed to boost the country's attractiveness to Japanese investors. The Bulgarian official also urged Mr. Kaifu to add Sofia to his January travel agenda.

As the Table indicates, Japan's economic relations with Eastern Europe have not been extensive. Thus, it is hard to credibly argue, as some analysts have, that Tokyo's recent pledge of generosity is motivated by a desire to protect sizable assets. While Japanese businessmen no doubt are eyeing Eastern European markets for possible expansion -- as they would evaluate any new market

Japan's Trade with Eastern Europe, 1980-88

(in millions of dollars)

	1980	1985	1986	1987	1988
Eastern Europe					
Exports	$807,217	$563,759	$682,026	$716,673	$775,831
Imports	255,760	316,214	344,519	475,903	691,611
Trade Balance	551,457	247,545	337,507	240,770	84,220
Bulgaria					
Exports	65,316	123,421	160,513	117,222	160,590
Imports	22,071	22,118	18,087	24,851	49,546
Trade Balance	43,245	101,303	142,426	92,371	111,044
Czechoslovakia					
Exports	63,466	56,935	61,759	63,086	48,243
Imports	49,379	53,110	56,886	80,817	116,819
Trade Balance	14,087	3,825	4,873	-17,731	-68,576
East Germany					
Exports	138,666	137,133	119,293	201,138	154,734
Imports	39,689	43,967	51,883	59,231	92,602
Trade Balance	98,977	93,166	67,410	141,907	62,132
Hungary					
Exports	107,320	83,247	82,271	91,733	101,338
Imports	17,447	52,306	61,265	97,928	163,816
Trade Balance	89,873	30,941	21,006	-6,195	-62,478
Poland					
Exports	228,176	73,214	146,087	166,862	258,037
Imports	61,571	67,443	55,779	75,587	115,989
Trade Balance	166,605	5,771	90,308	91,275	142,048
Romania					
Exports	202,655	89,566	111,476	76,436	52,597
Imports	65,577	65,045	95,415	132,756	142,175
Trade Balance	137,078	24,521	16,061	-56,320	-89,578

Source: Japan Tariff Association

opportunities -- the Japanese government's position appears to be influenced more by a desire to demonstrate that it recognizes Japan's obligation to assume greater responsibility for global economic problems. The Soviet Union's glasnost policy also may have made it easier for Tokyo to contemplate a new policy toward this region since it appears that some Warsaw Bloc countries no longer want to follow Moscow lockstep.

Barbara Wanner

Congressional Measures Target Foreign-Owned Companies

Foreign governments, including Japan, have been lobbying against a low-profile provision in both the House-passed deficit-reduction bill and its Senate counterpart that increases tax reporting requirements for American companies controlled by foreign owners. Capitals around the world believe the measure could discourage foreign investment in the United States. For the same reason foreign governments also are concerned about three other tax-related provisions in the House bill (but not the Senate version) that would affect foreign investors.

The deficit-reduction package, formally known as the Omnibus Budget Reconciliation Act of 1989, currently is in the hands of a conference committee where members are trying to combine the House-passed bill, HR 3299, and the Senate Finance Committee version, but the participation of 231 conferees is expected to slow progress indefinitely. A capital gains tax cut and the repeal of catastrophic health insurance are among the major measures attached to the legislation, and they are taking center stage during the conference committee debate.

Both the House and the Senate provisions regarding Internal Revenue Service reporting requirements for domestic companies owned by foreigners are designed to increase compliance with U.S. tax laws, their sponsors say, but the two measures differ on specifics. For example, while Section 6403 of the Senate Finance bill requires that appropriate records be kept, Section 11403 of the House version specifies that the records be maintained in the United States. Moreover, the number of foreign businesses potentially affected varies because each chamber has its own definition of foreign ownership. The Senate Finance provision says a company is foreign-owned when 25 percent of its stock or value is held by one nondomestic party, whereas HR 3299 defines a foreign-owned business as a company that is 25 percent owned by a group of foreign shareholders, of which at least one has a stake of 10 percent or more.

Regardless of the definition of foreign ownership, foreign governments believe that the proposed reporting requirements would undermine the tax treaties the United States has with countries such as Japan, Canada and the United Kingdom since these treaties contain effective procedures for exchanging information to determine U.S. tax liability. It also is argued that the provisions in the House and the Senate bills would place a heavier reporting burden on foreign-affiliated firms than on domestic companies, especially if records had to be maintained in English and in dollar terms. Therefore, foreign governments add, the measures violate bilateral tax treaties, which forbid discrimination against foreign-owned businesses with respect not only to taxation but also to related reporting requirements and other rules.

Notes

Opposition Tax Bills - Opposition parties, which organized as a coalition in the current special Diet session, submitted to the upper house October 26 a two-year package of tax increases to finance the revenue loss from the proposed repeal of the 3 percent consumption tax. They had introduced their plan to abolish the consumption tax at the September 28 opening of the current session (see JEI Report No. 38B, October 6, 1989).

The major components of the package are: the reintroduction of commodity taxes to raise Y1,269 billion ($9.1 billion at Y140=$1.00); the cancellation of a planned cut in corporate tax rates for Y1,380 billion ($9.9 billion); an increase in the withholding tax applicable to stock sales for Y625 billion ($4.5 billion); a hike in the top rates of the inheritance tax and the gift tax for Y7 billion ($50 million); the revival of certain local indirect taxes for Y1,250 billion ($8.9 billion); and a growth-linked revenue increase of Y1,409 billion ($10.1 billion). The Japan Socialist Party and the Democratic Socialist Party resolved a major political rift over the proposed commodity tax rate for cars and trucks by agreeing to set it at 8 percent of the factory price, which tax analysts calculate is equivalent to the current 3 percent consumption tax on the retail price. The projected total of Y5,940 billion ($42.4 billion) that would be raised by these measures in FY 1990 is said to be enough to recover the revenue lost from the repeal of the consumption tax.

The opposition's tax package is expected to be debated for three to four weeks before reaching a floor vote, according to Hiroshi Mitsuzuka, chairman of the Liberal Democratic Party's policy committee. He suggested that the LDP will join the discussion rather than throw up a roadblock to stop the debate. If so, the bills could pass the opposition-controlled upper house in late November and run head-on into the LDP tax reform plan being reviewed in the lower house, where the LDP has a majority. What might happen then is uncertain, but the outcome is expected to influence whether lower house elections will be held, as currently rumored, in late February 1990.

Manufactured Imports - Four years ago Japan's imports of manufactured products added up to $36.4 billion. In 1989 purchases of foreign machinery, transportation equipment, precision instruments, chemicals and other finished industrial inputs and consumer goods are expected to top $100 billion, thanks to the strong yen, robust domestic demand and the spreading awareness among big Japanese companies of the benefits -- both political and economic -- of buying foreign (see Table). Yet this spectacular growth is unlikely to end complaints from American trade policymakers, manufacturers and economists that Japan's imports of manufactured products are too low -- whether measured as a share of total overseas purchases (about 47 percent versus nearly 80 percent for the United States and 60 to 70 percent for European countries) or on a per capita basis (less than half the comparable number for other leading industrial nations.)

Over the last year or so overseas critics of Japan's track record on manufactured imports have gained an unexpected ally in Tokyo: the Ministry of International Trade and Industry. MITI's initial import promotion efforts were limited mainly to jawboning 300-plus big Japanese importers and manufacturers to expand their purchases of finished products from abroad by 30 percent a year. But with the slower growth of manufactured imports this year signaling that the easy gains already have been made and analysts projecting an increase in Japan's trade surplus in 1990, MITI has unveiled a plan to provide direct support for larger purchases of manufactured goods from foreign suppliers.

Japan's Imports of Manufactured Products*

(in millions of dollars, c.i.f. value)

	1980	1985	1986	1987	1988	Eight Months 1989
Chemicals	$6,202	$8,072	$9,733	$11,845	$14,830	$11,008
Manufactured Goods Classified by Material	10,579	10,886	12,390	18,055	27,340	20,229
Machinery and Transport Equipment	8,756	11,106	13,283	17,264	24,727	19,194
Miscellaneous Manufactures	5,031	6,349	8,634	13,396	18,702	15,058
Manufactured Imports	30,568	36,413	44,040	60,560	85,599	65,489
Total Imports	140,528	129,539	126,408	149,515	187,354	138,314
Manufactures/Total Imports	21.8%	28.1%	34.8%	40.5%	45.7%	47.3%

*SITC 5-8.

Source: Japan Tariff Association

The centerpiece of the new initiative, proposed to go into effect next April, is a tax write-off for companies that boost imports of manufactures on a year-to-year basis. Although the size of the credit still is being discussed, the figures MITI has floated to the press indicate that it has a fairly modest tax break in mind -- something on the order of Y30 billion ($214.3 million at Y140=$1.00) in FY 1990 compared with projected corporate tax payments of Y18.4 trillion ($131.2 billion) in the current fiscal year. Still, ministry policy planners are hopeful that the plan provides enough of an incentive to get the huge number of small and midsized companies, which have been slow to increase manufactured imports, to expand offshore sourcing.

The response of foreign manufacturers to MITI's proposal has been muted, but it is not hard to second-guess the probable majority reaction: irked that Japanese companies might need tax incentives to break their buy-national purchasing practices but thankful for any help they can get in expanding sales. In Japan most manufacturers and importers had little to say about the plan, although spokesmen for industries that no longer are internationally competitive criticized the latest idea for boosting imports. Ministry of Finance officials were not so reticent, arguing that Japan already had done enough to expand imports and that big companies were more likely to benefit from the proposed tax break than MITI's primary target, small and midsized firms. That reaction has led analysts to conclude that if any money is included in the FY 1990 budget for the MITI plan, it will be even less than the modest amount currently being discussed.

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REPORT

A Two-Part Report: A and B

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STRUCTURAL CHANGES IN JAPAN'S DISTRIBUTION SYSTEM

Summary

Japan's distribution system, once regarded as politically sacrosanct, now is under siege. The United States perceives the distribution system as a major obstacle to increased imports and has placed the issue at the top of its agenda in the Structural Impediment Initiative talks. In addition to the United States, European Community countries have urged the Japanese government to grapple with this problem to ease trade frictions and eventually reduce trade imbalances. Responding to this criticism as well as pressure for change at home, the Japanese government has begun to consider how to reform the distribution system and related business practices and government regulations.

Significant changes in lifestyles and consumption patterns already are affecting the distribution system. Whether these shifts and the increasing emphasis on a service-oriented economy will propel politicians and the bureaucracy to facilitate the modernization of the system remains to be seen. In particular, the government will be looking at the close ties between manufacturers and retailers and how this affects imports. The country also is hearing calls for repeal of or at least changes in the Large Retail Store Law. However, the consumerism that blossomed in the late 1980s is unlikely to end, and that development has spin-off effects for the distribution system, including the potential for modernization.

Overview of the Distribution Sector

Japan's distribution system is characterized as an inefficient and multilayered structure made up of numerous small retail and wholesale stores.

Japan had just over 1.6 million retail stores and nearly 437,000 wholesale establishments as of 1988. These figures were not so different from the numbers for the United States, which in 1982 (the latest year for which census data are available) had 1.5 million-plus retail outlets and about 416,000 wholesale establishments, but they were four or more times higher than the equivalent numbers for the United Kingdom, France and West Germany (see Table 1). When the population difference between Japan and the United States is taken into account, however, Japan -- with nearly half the population of the United States crammed into an area roughly the size of California -- had about 132 retail stores and 36 wholesale establishments per 10,000 people, twice as high as the comparable U.S. figures.

Table 1: International Comparison of Retail and Wholesale Businesses

	Japan (1988)	United States (1982)	United Kingdom (1982)	France (1982)	West Germany (1985)
Number of Retail Stores (thousands)	1,620	1,542	343	472	407
Number of Wholesale Establishments (thousands)	437	416	95	78	119
Number of Retail Stores per 10,000 People	132	66	61	87	67
Number of Wholesale Establishments per 10,000 People	36	18	17	14	19
Number of Retail Stores per Wholesale Establishment	3.7	3.7	3.6	6.1	3.4

Source: Adapted from Ministry of International Trade and Industry, Vision of the Distribution Industry in the 1990s, June 1989.

The average number of employees per retail outlet was 4.2 in 1988 in Japan, much smaller than the 1982 U.S. figure of 6.4. Another indication of the small size of Japanese retail operations is that stores with one to nine employees represented 93.3 percent of all outlets last year compared with a figure of 80.5 percent for the United States in 1982. Japan, however, is not unique in this regard. France's retail network also is characterized by a multiplicity of small, primarily mom-and-pop, outlets (see Tables 2 and 3).

A good indicator of whether a country's distribution system is multilayered is the ratio of wholesale to retail sales. Japan's 1988 figure of 3.89, although slightly overstated because of the unique distribution role of trading

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Table 2: International Comparison of Employees per Retail Store

	Japan (1988)	United States (1982)	France (1982)	West Germany (1985)
Number of Employees (thousands)	6,851	12,846	1,627	1,931
Number of Employees per Store	4.2	6.4	4.2	13.6

Source: Adapted from Economic Planning Agency, Seventh Report of Study Group on Distribution, March 1989.

Table 3: International Comparison of Size of Retail Stores

Number of Employees	Japan (1988)	United States (1982)	France (1982)	West Germany (1985)
1-2	54.0%	40.0%	66.7%	14.7%
3-9	39.3	40.5	30.1	62.8
10-19	4.3	10.4	1.9	14.7
20-49	1.9	6.5	1.0	5.7
50-99	0.3	1.9	0.2	1.2
100 and Over	0.1	0.7	0.2	0.9

Source: Adapted from Economic Planning Agency, Seventh Report of Study Group on Distribution, March 1989.

companies (sogo shosha), stands out from that of its major trading partners: 2.08 in the United States (1982), 2.03 in the United Kingdom (1982), 1.57 in France (1982) and 1.67 in West Germany (1979). A comparative look at relative productivity also highlights the fact that Japan's distribution sector has a long way to go to catch up with its efficient manufacturing sector, not to mention other countries. In 1985 the relative productivity of the Japanese distribution system was 59.4 percent (manufacturing productivity counted as 100) versus 67.8 percent for the United States, 71.1 percent for France and 78.4 percent for West Germany.

Changes in the 1980s

Once Japan's distribution system was regarded as stable, an unchanged structure over time. But now it is undergoing dramatic, rapid change. Between World War II and 1982 the number of retail stores increased at a stable 1 to 2 percent a year. At the peak in 1982 there were more than 1.7 million shops; by 1988 that number had decreased 5.9 percent to just over 1.6 million. Most of this reduction came from the rapid decline in the number of mom-and-pop stores (see Table 4). In 1982 60.2 percent of all shops or 1 million-plus had one or two employees; six years later the figure was 54 percent or 874,330, a drop of 15.6 percent. This decline was accompanied by increased numbers in all other size categories; for example, stores with 10 to 19 employees jumped 30.3

Table 4: Size Structure of Japan's Distribution Sector

Retail Industry

Number of Employees	1982 Outlets Number	1982 Outlets Share	1985 Outlets Number	1985 Outlets Share	1988 Outlets Number	1988 Outlets Share
1-2	1,036,000	60.2%	940,000	57.7%	874,330	54.0%
3-4	413,000	24.0	408,000	25.0	422,025	26.1
5-9	188,000	10.9	190,000	11.7	213,999	13.2
10-19	54,000	3.1	58,000	3.6	70,382	4.3
20-29	15,000	0.9	15,000	0.9	19,183	1.2
30-49	9,500	0.6	10,000	0.6	12,249	0.8
50-99	4,500	0.3	4,800	0.3	5,361	0.3
100+	1,900	0.1	2,000	0.1	2,070	0.1
Total	1,721,465	100.0	1,628,644	100.0	1,619,599	100.0

Wholesale Industry

Number of Employees	1982 Establishments Number	1982 Establishments Share	1985 Establishments Number	1985 Establishments Share	1988 Establishments Number	1988 Establishments Share
1-2	100,000	23.3%	93,000	22.5%	95,340	21.8%
3-4	108,000	25.2	105,000	25.4	110,109	25.2
5-9	120,000	28.0	115,000	27.8	121,646	27.9
10-19	61,000	14.2	59,000	14.3	64,689	14.8
20-29	18,000	4.2	18,000	4.4	20,078	4.6
30-49	13,000	3.0	12,000	2.9	13,898	3.2
50-99	7,000	1.6	6,900	1.7	7,786	1.8
100+	2,800	0.7	2,700	0.7	2,956	0.7
Total	428,858	100.0	413,016	100.0	436,502	100.0

Source: Ministry of International Trade and Industry, Census of Commerce.

percent to 70,382 last year. At the same time, the proportion of retail stores owned and operated by individuals, which peaked at 79.4 percent in 1976, has fallen by a significant margin and, similarly, the share of sales generated by these sole proprietors has dropped considerably from 1976's all-time high of 29.8 percent.

Another sign of the changing structure of Japan's distribution system is the rapid spread of convenience stores, such as 7-11, and discount outlets and the growth of mail-order businesses. Among the increased numbers of two-income families or women working part-time in urban areas, the time available to go shopping for daily needs is limited. Convenience stores, with their longer business hours -- often open 24 hours in many areas of central Tokyo -- and broader choice of products from food and cosmetics to magazines, are more attractive to busy consumers than ordinary small retail stores. As they have gained in popularity, some convenience stores have started to offer rental videos, fast delivery of small parcels (takkyu-bin) and liquor. Since a convenience store with a liquor section is regarded as the most competitive, it is no surprise that industry leader 7-11 is eagerly expanding its liquor business.

Discount consumer electronics outlets, a rather new business, also are popping up in major cities. By buying large quantities of goods from a primary wholesaler, these stores skip the multilayered distribution network and can sell products at deeply discounted prices. Contrary to accepted Japanese practice, there usually is no delivery, no wrapping, no insurance, no installment payment plan, no explanation of how to use the item and sometimes no products on display. Since these shops sell televisions, stereos and similar products for 10 to 20 percent below normal prices, they are very crowded with young people.

The mail-order business, too, is prospering because it saves shopping time and offers a wide choice of merchandise. According to the white paper on small and medium-sized businesses drafted by the Ministry of International Trade and Industry, the leading reason given for choosing a shopping place 10 years ago was a store's proximity to home rather than price. However, more and more consumers now say the ability to buy various goods at one time and at low prices ranks equally as high as proximity. The rapid increase in convenience stores and other nontraditional outlets reflects a change both in consumer behavior and in lifestyles.

Table 5 underscores the changing structure of Japan's retail sector, even allowing for some double-counting, for example between franchise chains and convenience stores. A report by Nikkei Ryutuu Shinbun showed similarly big gains for the new retail channels in FY 1987, including 17.5 percent for convenience stores, 12.2 percent for discount stores and 18.1 percent for mail-order businesses.

Table 5: Changes in Sales by Different Types of Retail Businesses in Japan

	Average Annual Growth Rate 1982-85	Average Annual Growth Rate 1985-88
Department Stores	3.7%	6.2%
Shopping Centers	6.5	4.4
Voluntary Chains	7.0	7.5
Franchise Chains	4.9	14.7
Convenience Stores	15.8	---
Discount Appliance Outlets	12.5	14.9
Mail Order Businesses	9.1	17.7
Total Sales	2.7	4.1

Note: Some retail services appear in more than one category.

Source: Ministry of International Trade and Industry, Vision of the Distribution Industry in the 1990s, June 1989.

Business Practices in Japan

Despite American perceptions, Japanese retail and wholesale practices are not all that different from those in the United States. Key elements of commercial success include high product quality, low prices, quick delivery and full repair services. If the conventional wisdom were right, for example, the distribution sector would not have undergone the structural changes of the past few years, and Japanese consumers most likely would have many more complaints about the retail industry. Having said that, the fact remains that at least three business practices are unique to Japan's distribution system.

For certain goods retailers are able to return merchandise to wholesalers to allow new product displays or a change in seasonal products or simply to get rid of unsold products. According to the Japan Chamber of Commerce and Industry, this product return system allows retailers to avoid the risk of not selling items and makes it easier for manufacturers to get their goods displayed in stores and to market new products. While this approach distributes sales risks over the entire system, the related administrative costs drive up the overall costs of doing business and, in turn, retail prices. Since this system does not apply to imported products, retailers have a disincentive to handle foreign merchandise.

The product return system is an outgrowth of the historically weaker economic status of retail stores compared with relatively large wholesalers and manufacturers. The upstream part of the chain protected the interests of small retail stores by sharing sales risks. However, recent trends in the retail end of business -- the upsurge of convenience and other nontraditional stores and the decline in the number of mom-and-pop shops -- suggest that the product return policy will be less important in the future, with the result that retailers will have more leeway to decide prices and how to handle goods on their own.

Also unique to the Japanese distribution system are the transactions among companies that are part of the same corporate group or *keiretsu*. Retailers often are affiliated with manufacturers in such industries as motor vehicles, home appliances and consumer electronics, and cosmetics. It is said that manufacturers of consumer goods encouraged this system as an effective way to expand their business in the era of double-digit economic growth in the 1960s and early 1970s. There is no prima facie evidence that transactions among group members violate antitrust statutes, although these dealings admittedly are exclusionary to some extent. Retailer competition among keiretsu is strong as the groups attempt to get a higher market share. As such, many in Japan's business community believe that the possibility of antitrust violations should be reviewed on a case-by-case basis. Still, it is undeniable that the existence of the keiretsu makes it difficult for foreign manufacturers to compete and thereby limits the expansion of imports.

Another criticism stemming from the linkage between manufacturers and retailers in a keiretsu focuses on manufacturers' suggested prices and a complex system of rebates. Manufacturers frequently suggest a price to retail stores in a bid to ward off cutthroat competition. Strengthening this system is a complex rebate mechanism. Economists who suspect this process of freezing out distributors of competitive products suggest that the Antimonopoly Law be applied strictly to protect the consumer's interest and that keiretsu activity be monitored closely.

A third unique aspect of Japan's distribution network is the system of sole import agents, which in the past worked effectively to encourage imports.

Historically, foreign-made products were introduced to the market as highly prestigious, expensive items. Thus, the sole import agent and the overseas producer tended to keep prices high to maintain the image of the imported good and to make as much money as possible. This pricing strategy is not illegal by itself, but if the sole import agent does anything to restrict competition, this could be construed as a violation of the antitrust law. (A current, related investigation involves Apple Computer Japan Inc. and its sales agent, Canon Sales Co., Ltd. For details see JEI Report No. 39B, October 13, 1989.) As parallel imports -- brand-name products obtained overseas independent of foreign manufacturers' sole agents in Japan -- increase, there is a growing possibility that the sole import agent system will become less of an obstacle to expanded imports.

Much work has been done, both by the government and economists, on how to improve the distribution system and how to correct restrictive business practices. The goal seems to be to promote price competition by fostering the independence of retailers, in large part by freeing them of the pressure from domestic and foreign manufacturers to keep prices high. In this sense, antitrust enforcement is critically important for promoting imports as well as protecting the consumer's interest.

Government Regulation: Large Retail Store Law

The Large Retail Store Law, called Daitenhou in Japanese, was not intended to stymie the opening of department stores and supermarkets but rather to provide for a smooth adjustment of the interests between big retailers and surrounding small retailers. However, application of the law has proved different. From the standpoint of protecting the interests of small retailers, the law is very effective since it provides a way to significantly delay a large store's opening.

According to Article 5 of the Large Retail Store Law, the owner or the operator of a proposed store with a sales floor space of more than 1,500 square meters (16,146 square feet) must submit an application to the Ministry of International Trade and Industry at least five months before the planned opening; a company interested in opening a store with a selling area between 500 square meters (5,382 square feet) and 1,500 square meters is subject to the same requirement but the application goes to the prefectural government. If the planned store is part of a mall or similar shopping complex, the project's general contractor must submit an application to either MITI or the prefectural government (Article 3), depending on the size of the store, before the store files its application.

After the application is filed, the ministry or prefectural government must convey the relevant information, including the store's name, location, opening day, shopping space and hours of operating, to the retailers around the proposed site. A large store cannot open during the seven months following the filing of the Article 3 application since the authorities use this time to investigate and review the impact of the planned store on the local economy. The review includes an effort to determine the future sales of neighboring small stores based on the projected impact of the new outlet. If officials anticipate that the planned store will have a major impact, they can recommend that the owner delay opening or decrease the selling space. This determination must be made within four months of the receipt of the application from the owner.

Applications by stores with more than 1,500 square meters of selling space also are reviewed by the Council on Large-Scale Retail Stores, while plans for stores up to this threshold are examined by counterpart councils at the prefectural level. The councils hear the views of local chambers of commerce and the Council for Coordinating Commercial Activity, which consists of the local chamber of commerce, consumers and scholars. Having gathered their recommendations, the councils advise the authorities responsible for clearing the new store.

If the Large Retail Store Law were implemented as intended when it was enacted in 1974, any big store could open seven months after an Article 3 application had been filed since the interests of the new retailer and existing small retailers would have been reconciled. At the time of the law's enactment the adjustment process was expected to take a year or two. However, while the average period from the planning stage to the opening of a large store was four to five years 10 years ago, it now runs seven to eight years; in some instances the process takes 15 years.

The Large Retail Store Law initially applied only to stores with a sales floor space over 1,500 square meters. When department store and supermarket chains began to open stores all over the country with a selling area below this threshold, local governments drafted regulations on medium-sized stores. Bowing to this pressure in 1979, MITI extended the reach of the law to stores with a shopping area of 500 square meters. But this change did not resolve the conflicts between local governments, which were being lobbied by local merchants for tighter controls on the expansion plans of big retailers, and MITI. Finally in 1982 the ministry issued new guidelines governing the size of stores that could be opened in cities of varying population and beefed up the consultative role of localities on the opening of big retail operations. MITI also started to use administrative guidance to slow the spread of supermarket chains.

Despite MITI's attempts both to strengthen the Large Retail Store Law and tighten its implementation, many local government units remained dissatisfied. Currently, 20 of the 47 prefectures have stronger regulations than MITI's, while 233 municipal governments have their own versions. Generally, shops over 200 or 300 square meters (2,153 or 3,229 square feet) are subject to local regulation. In the extreme case, however, even the smallest store can come under scrutiny if it is owned by people from outside the area.

Local interest groups have distorted implementation of the Large Retail Store Law from the beginning. The law provides that the Council on Large-Scale Retail Stores be only an advisory organization to coordinate interests between a major store and small stores. This council, in turn, must take into account the voice of the Council for Coordinating Commercial Activity, but under MITI guidelines CCCA has just three weeks to come up with a recommendation. Since this process did not give local merchants enough time to thwart the opening of big stores, they created an informal organization called a pre-CCCA and eventually succeeded in carving out a pivotal role for this new body.

As the system works now the owner or the operator of a planned large store must gain a pre-CCCA's approval for such things as the size of the selling space and business hours before it files a formal Article 5 application. During these negotiations the pre-CCCA has the upper hand because there are no time limits on its activities. And this is not the only roadblock since small retailers also came up with another informal group -- a pre-pre-CCCA -- that must be consulted before a general contractor can file an Article 3 application. The operations of both the pre-CCCA and the pre-pre-CCCA lack transparency, and this gives them the power to indefinitely delay a store's opening. Many department store and supermarket chains consider the two groups' actions to be illegal harassment.

With pressure for change building at home and abroad, a MITI advisory panel recommended in early June that the Large Retail Store Law should be applied more flexibly to get back to its original intent. Among the proposed changes are:

- The first notice of a proposed business complex, given before an Article 3 application is filed by the general contractor, simply should present the necessary information about the planned project. This is an attempt to limit the influence of the pre-pre-CCCAs, which have used this notification step to extract concessions.

- The review period for pre-CCCAs should be limited to eight months. If agreement cannot be reached within that period, the review should be transferred to the CCCA itself or to the Council on Large-Scale Retail Stores.

- Regulations covering business hours, the number of days a year a store is closed and related matters should be relaxed.

- Overly strict local regulations should be revised in line with the Large Retail Store Law.

MITI, however, is unable to begin implementing these suggested changes because of pressure from Liberal Democratic Party members worried about losing the political support of small retailers. Already nervous about losses the ruling party suffered in the July upper house elections, they fear they could lose their seats in the coming lower house elections if they endorse MITI's reforms.

In some business circles it is argued that the Large Retail Store Law is outdated and should be abolished immediately. But the consensus is that the proposed changes in implementation would be a good first step and that more flexibility can be expected in the future. External pressures also are being brought. U.S. agencies, such as the Office of the U.S. Trade Representative and the Commerce Department, maintain that the proposed steps are inadequate and that the Large Retail Store Law must be repealed to help increase imports (see JEI Report No. 24B, June 23, 1989). If the LDP fails to satisfy the United States, the Structural Impediments Initiative talks could be in jeopardy and Japan's distribution system possibly could be taken up within the framework of the Super 301 provision of the 1988 Omnibus Trade and Competitiveness Act.

It is unclear how MITI, caught between the conflicting demands of the LDP and the United States, will resolve its dilemma. What is sure, however, is that how Tokyo handles problems related to the Large Retail Store Law and whether it is prepared to strictly enforce the Antimonopoly Law will be regarded overseas as the first test of Japanese willingness to address structural reform and to coordinate its economic policies with those of other industrialized countries.

For further information, contact Hideo Takahashi.

APPENDIX

Distribution Sector Indicators, 1982, 1985 and 1988

	1982	1985	1988
Retail Industry			
Number of Outlets	1,721,465	1,628,644	1,619,599
Retail Outlet/Wholesale Establishment Ratio	4.01	3.94	3.71
Number of Employees	6,369,000	6,329,000	6,850,478
Number of Employees per Outlet	3.7	3.9	4.2
Population per Retail Employee	18.6	19.1	17.9
Annual Sales (million yen*)	Y93,971,000	Y101,719,000	Y114,829,000
Annual Sales per Outlet (thousand yen*)	Y54,588	Y62,456	Y70,900
Annual Sales per Employee (thousand yen*)	Y14,754	Y16,072	Y16,762
Selling Space (thousand square meters)	95,430	94,507	102,096
Annual Sales per Square Meter of Selling Space*	Y984,711	Y1,076,312	Y1,124,716
Per Capita Sales*	Y791,481	Y840,313	Y935,242
Sales/Inventory Ratio	9.4	10.3	9.8
Wholesale Industry			
Number of Establishments	428,858	413,016	436,502
Number of Employees	4,091,000	3,998,000	4,331,681
Number of Employees Per Establishment	9.5	9.7	9.9
Population per Wholesale Employee	29.0	30.3	28.3
Annual Sales (million yen*)	Y398,536,000	Y428,291,000	Y446,423,000
Annual Sales per Establishment (thousand yen*)	Y929,296	Y1,036,984	Y1,022,728
Annual Sales per Employee (thousand yen*)	Y97,418	Y107,126	Y103,052
Wholesale/Retail Turnover Ratio	4.24	4.21	3.89

*The following average annual exchange rates can be used to convert the yen figures: 1982, Y249.08; 1985, Y238.54; and 1988, Y128.15.

Source: Ministry of International Trade and Industry, Census of Commerce.

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The views expressed in this report are those of the author and do not necessarily represent those of the Japan Economic Institute.

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PACIFIC ECONOMIC COOPERATION: WASHINGTON'S NEW ASIAN STRATEGY?

Summary

Over the last year or so the United States has championed the idea of an Asia Pacific economic entity. Political analysts have suggested that Washington's initiative is motivated by U.S. concerns about containing Japan's economic presence in this region as well as its desire to create an economic counterweight to the soon-to-be-integrated European Community. While these developments no doubt form an important backdrop, it appears that Washington's interest in an Asia Pacific economic organization stems primarily from a recognition that U.S. foreign policy must be adapted to reflect changed political and economic conditions in this part of the world.

Whether the concept of Asia Pacific economic cooperation actually can be implemented remains to be seen. Certain political and organizational issues, such as structure, membership and scope, wait to be addressed. A November 6-7 meeting in Canberra, Australia only introduced participating Pacific Rim nations to the complexities of establishing formal economic links.

Asia Pacific: A Region in Transition

The concept of enhancing economic cooperation in the Pacific region is an idea "whose time seems to have come," a phrase repeated by many of those involved in such discussions. After at least 10 years of consideration in a variety of government and private-sector forums, representatives of 12 governments of the Asia Pacific region met in Canberra, Australia November 6-7 in an effort to implement this vision. Participating were: the United States, Canada, Japan, Australia, New Zealand, South Korea and the countries of the Association of Southeast Asian nations (Singapore, Thailand, Indonesia, Malaysia, the Philippines and Brunei). Although the Asia Pacific Economic Cooperation Conference did not produce a formal structure for regional economic cooperation, the meeting nevertheless was a "clear and substantial step forward for international relations" and will pave the way for further discussions, according to Secretary of State James Baker.

What has increased the attractiveness of a regional economic grouping in this part of the world? Government and private-sector officials who actively have sought to foster this entity maintain that changes in the Asia Pacific political and economic environment have created an atmosphere more amenable to multilateral cooperation. Richard Fairbanks, president of the U.S. National Committee for Pacific Economic Cooperation, a private organization comprised of regional business, government and academic leaders, points out that the reduction of political tensions in the Asia Pacific over the past 15 years has allowed interest in regional economic cooperation to blossom. In addition to the protection provided by the U.S. security umbrella, "the relaxation of tensions following normalization of U.S. relations with China, the end of the Vietnam War, and the rapprochement between the Soviet Union and China all are factors that have made it easier for policymakers in the region to focus more of their attention on economic relationships," Mr. Fairbanks told the Senate Foreign Relations subcommittee on East Asia and Pacific Affairs at its September 21 hearing on this subject.[1]

Economic growth in Asia has soared over the past decade; the largest economies of the Asia Pacific region together now account for an estimated 24 percent of the world's gross national product, which is roughly equal to the U.S. share. Regional economic interdependence also has expanded; the share of intraregional trade among the economies of Asia Pacific countries grew from about 50 percent in 1970 to more than 65 percent in 1987. In particular, trade with this part of the world now accounts for more than one-third of America's total foreign commerce. In fact, at $280 billion in 1988, U.S. transpacific trade overshadowed by nearly 50 percent the $190 billion in transatlantic trade.

Investment flows also have helped to integrate regional economies. The net book value of U.S. direct investment in East Asia alone now exceeds $33 billion. Although accounting differences make a precise comparison difficult, Japanese direct investment in the region at least approximates and now may even exceed the U.S. level (see JEI Report No. 31A, August 11, 1989). Taiwan and South Korea, rapidly maturing beyond the newly industrialized economy category, also are expanding investment in the region as rising labor costs have forced them to seek overseas manufacturing sites.

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[1] Testimony by Richard Fairbanks, president, U.S. National Committee for Pacific Economic Cooperation, before the Senate Foreign Relations Subcommittee on East Asia and Pacific Affairs, September 21, 1989, p. 3.

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The largely export-driven economies of Asia have flourished due partly to the relatively unimpeded access to the U.S. and other global markets. However, the dynamic economic growth and interdependence that this part of the world has realized during the past decade has, in turn, generated adjustment problems as the global trading system has been forced to accommodate sharply expanded Asian exports. The large and persistent U.S. trade deficit, at least with the 11 other countries of the Asia Pacific that met in Canberra ($83.8 billion in 1988), has created a growing domestic constituency that advocates protectionist barriers as a way of rectifying the trade imbalance. Specifically, Washington's call for negotiations on unfair trade practices under the Super 301 provision of the 1988 trade act has heightened concerns in Asian countries that they progressively may be shut out of this critical market.

Other developments that Asian countries appear to view as potential harbingers of a less open trading system include the U.S.-Canada Free Trade Agreement, which went into effect in January 1989. Nations in Asia fear this accord could usher in an era of other restrictive bilateral arrangements. Another threat is seen in the European Community's plan to fully integrate its members' economies by 1992. In addition, given the snail's pace of the Uruguay Round of multilateral trade negotiations, some regional officials are not completely confident that the trade system based on the General Agreement on Tariffs and Trade can address the variety of new economic pressures.

The United States and its Asia trading partners therefore have found themselves confronted with the need to find new ways of tackling commercial frictions so that the free trading system that gave rise to their prosperity is not destroyed. According to Mr. Fairbanks, rather than undermining the prospects for regional economic cooperation, the strains of economic adjustment have "added a shared sense of urgency that [the United States and Japan as well as the other nations in the region] must find a better means for addressing trade frictions."[2]

Pacific Economic Cooperation Gains Momentum

The concept of a mechanism for Pacific economic cooperation for many years had been advanced by academics and businessmen who viewed it as a means to further propel the region's economic development. Unlike the European continent, however, the vast geographic, social and cultural diversity of this part of the world presents formidable obstacles to formal integration. In addition, unlike in Europe, the levels of economic development in the Asia Pacific vary tremendously, ranging from the highly developed U.S. and Japanese economies to developing nations, such as Indonesia and Malaysia, with NIEs like South Korea in the middle. This broad spectrum has inhibited development of a regional economic structure.

Nevertheless, several semiofficial or private-sector economic organizations have evolved during the past decade in an effort to fill a perceived need for forums in which to address the region's expanding economic imperatives. The Pacific Economic Cooperation Council was launched in 1980 at the suggestion of then Australian Prime Minister Malcolm Fraser and then Prime Minister Masayoshi

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[2] _Ibid._, p. 4.

Ohira. Comprised of 15 Asia Pacific country members[3], PECC allows business-leaders, academics and government officials (participating in a private capacity) to come together to discuss a broad range of trade, economic and financial issues confronting the region. Since it is not an "official" entity, the organization has enabled countries that do not have diplomatic relations, such as China and Taiwan, to come together to discuss economic issues. According to Mark Borthwick, executive director of the U.S. National Committee for Pacific Economic Cooperation, the U.S. representative body at PECC, up until this point the existence of the organization has allowed governments in the region to maintain a dialogue without having to commit to something larger or more formal.

Another private-sector organization that has strived to facilitate intraregional communication is the Pacific Basin Economic Council, a San Francisco-based organization of business executives from Asia Pacific countries formed in 1968. During that same year the Pacific Trade and Development Conference also was established as a vehicle to bring together leading economists from the region on an annual basis to deliberate a single issue of importance to the Asia Pacific.

The Asian Development Bank and the United Nations Economic and Social Commission for Asia and the Pacific are the primary governmental bodies in the region. However, these organizations do not really serve as forums where nations in the region can discuss specific economic issues or problems. Their membership also extends to countries that are not directly involved in the region.

Both PECC's Mr. Borthwick and R. Sean Randolph of PBEC concur that global and regional economic developments during the past two years have created an environment more conducive to establishing a formal mechanism that would implement the regional economic cooperation concept. "For the first time there is real momentum and support in the governments for [a formal entity]," Mr. Randolph recently was quoted as saying.[4] Mr. Fairbanks maintains that the region is entering an important pivotal period. "In 1989 we have reached an important juncture in the development of a new framework for regional cooperation. Although some governments disagree on the specific blueprint a forum should take, there is a consensus that some expansion and elevation of the dialogue on economic and trade issues should be undertaken," he told the Senate Foreign Relations panel.[5]

While the debate has accelerated since the first of the year, former Secretary of State George Shultz may well have set the ball in motion. In a July 1988 proposal Mr. Shultz reportedly suggested the creation of a "Pacific

[3] The 15 members of PECC are: Australia, the six Asean nations (Singapore, Indonesia, Malaysia, Thailand, the Philippines and Brunei), Canada, China, Japan, South Korea, New Zealand, the Pacific Islands, Taiwan and the United States.

[4] Stuart Auerbach, "The Pacific Economic Compact: Bob Hawke's Plan Moves It Closer To Reality," The Washington Post, August 16, 1989.

[5] Fairbanks, op. cit., p. 12

Basin forum where like-minded countries could compare experiences, discuss ideas and prepare analyses of subjects that are of interest to most countries in the region."[6] Sen. Bill Bradley (D, N.J.) followed this lead with his December 1988 proposal calling for a coalition of eight Pacific Rim economies to "reinforce the Uruguay Round of GATT, enhance policy coordination and remove obstacles to less-developed country growth." Sen. Alan Cranston (D, Calif.), in turn, sponsored a resolution calling on President Bush to initiate a Pacific Basin forum that would hold annual summit meetings to discuss economic, security and political issues unique to the region. This recommendation subsequently was included as an amendment to the fiscal 1990 State Department authorization bill.

It was Australian Prime Minister Bob Hawke, however, who, in a speech in Seoul, South Korea this past January, effectively set the stage for concerted action. The Australian leader proposed establishment of a Pacific version of the Europe-based Organization for Economic Cooperation and Development to support GATT-led trade liberalization and encourage policy coordination. Joining the rising chorus on both sides of the Pacific calling for establishment of a formal regional mechanism, Mr. Hawke maintained that a secretariat, among other administrative organs, was needed to provide support for ongoing high-level meetings. While lauding the important role PECC has played in facilitating regional discussions, Mr. Hawke maintained that "its informality, which has helped to broaden its membership, also has made it difficult for it to address policy issues that are properly the responsibilities of governments."

Political analysts maintain that the Hawke initiative stood apart from the others in part because the prime minister pursued it aggressively as a key component of Australia's foreign policy.[7] Recognizing the broad-based support for an Asia Pacific economic grouping, Mr. Hawke seized the issue at a timely moment. There is a view that the prime minister's initiative reflected Australia's recognition that while most of its population derives from Western Europe, the country's economic interests are better served by integrating itself into the dynamic Asia Pacific economic framework. There is also speculation that Mr. Hawke feared that the European Community's 1992 integration and the recently implemented U.S.-Canada Free Trade Agreement were opening the door to a proliferation of regional trading blocs from which his country would be shut out.[8]

The Australian leader's initial membership list appeared to reflect his concern. Mr. Hawke originally proposed a core group, consisting of Asean members as well as Japan, South Korea, Australia and New Zealand but excluding the United States, Canada and China. After canvassing several East Asian nations as well as visiting Washington in early spring, the prime minister revised the plan to include the United States and Canada. Sydney's official line is that these two countries should be included since they are major forces in the Asia

[6] Testimony by Richard H. Solomon, assistant secretary of state for East Asia and Pacific affairs, before the Senate Foreign Relations Subcommittee on East Asia and Pacific Affairs, September 21, 1989, p. 9.

[7] Fairbanks, op. cit., p. 13.

[8] Auerbach, op. cit.

Pacific economy. The United States, in particular, as the main guarantor of regional security, is a natural partner for regional leadership, Australian officials point out. Other reports suggest that East Asian nations were keen on U.S. involvement as a means of curbing Japan's economic domination of the region. Memories of Tokyo's World War II occupation of the region are still quite vivid throughout Southeast Asia, and these countries tend to bridle whenever proposals are aired that urge an expanded Japanese presence in the region.

Nearly on the heels of the Hawke initiative, Tokyo also came forward with several ideas for regional economic cooperation. The Ministry of International Trade and Industry's 1988 trade white paper, for one, commits the Japanese government to fostering economic integration in East and Southeast Asia (see JEI Report No. 24B, June 23, 1989). One suggested means to this end was a network of free-trade pacts involving Japan, Asian NIEs and other developed and less developed nations. Specifically, some Japanese policymakers envisage the establishment of free-trade zones involving Japan, its Asian partners and the United States. Under this plan Japan would absorb U.S.-bound Asian exports in return for continuing free access to the American market.[9]

Following up on Prime Minister Hawke's call for a regional economic entity was Secretary of State Baker, who gave a big boost for U.S. pursuit of a "new Pacific partnership" at a June 26 Asia Society program in New York. Mr. Baker declared: "In Asia, as in Europe, a new order is taking shape. While the rites of passage will be painful . . . it is an order full of promise and hope. I believe strongly that the United States, with its regional friends, must play a crucial role in designing the architecture." According to the secretary of state, this new "architecture" will require three important components: continued American engagement in the region's politics, commerce and security; "more creative sharing" of global responsibilities with Japan; and a new mechanism for increased economic cooperation throughout the Pacific Rim.

As will be discussed below, the comprehensive nature of Mr. Baker's "new Pacific partnership" suggests that Washington may be rethinking its entire approach to U.S. regional relations. This is particularly apparent in Mr. Baker's strategy toward an Asia Pacific economic organization. Rather than offering a definitive plan, the United States has opted for an evolutionary, consensus-oriented approach that will draw on the best elements of the Australian, Japanese and other proposals.

Washington deliberately has sought to avoid imposing a "Made in America" blueprint for a regional economic grouping, according to Richard Solomon, assistant secretary of state for East Asia and Pacific affairs. "Given the history of unsuccessful efforts in this direction and the sensitivities involved, progress requires careful, incremental consensus-building if an economic cooperation mechanism is to be created," he told the Senate Foreign Relations panel.[10]

Secretary Baker was quite clear, however, that the United States believes that development of any new economic mechanism should be guided by the

[9] "On the Wing," The Economist, July 15, 1989, p. 11.

[10] Solomon, op. cit., p. 11.

following principles:[11]

- The organization should allow consideration of a wide array of issues -- not just trade and investment matters -- but those related to transportation and communications, resource management and the environment.

- Any Pacific-wide institution must further existing efforts to liberalize trade and investment, such as the Uruguay Round, OECD, or Asean.

- The structure and agenda of a Pacific cooperation entity should take into account the diversity of the region's social and economic systems and different levels of development.

- Membership in such an organization must begin with those economies committed to free-market policies but should remain open to eventual participation by those countries still in the early process of economic reform.

- The organization should be able to adapt to the changing needs of regional economic activity.

Despite the major powers' efforts not to impose their ideas on the rest of the region, Asean countries have not shared the same level of enthusiasm for the Baker or the Hawke visions of regional economic cooperation. Their resistance has been somewhat curious in view of the fact that several of them stand poised to "graduate" into the NIE category. Asean's real economic growth in 1988 averaged 7.3 percent, up from 5.5 percent in 1987, according to International Monetary Fund statistics. Among Asean members, Thailand and Malaysia led the group last year with inflation-adjusted growth rates of an impressive 11 percent. (Real American and Japanese growth rates, in comparison, were only 3.9 percent and 5.7 percent, respectively). Thus, this group of countries would appear to have the most to gain from closer cooperation with more advanced economies.

Asean countries are worried that an Asia Pacific economic entity, particularly one with American and Japanese membership, would undermine the organization's regional influence, which has grown considerably following the U.S. withdrawal from Vietnam. "In principle, we don't want to lose our identity. Asean will be the basis of unity for us," an Asean official has been quoted as saying.

Although originally conceived as an economic association, Asean in recent years has gained a political dimension, as reflected in its efforts to resolve the Cambodian situation. In particular, its annual ministerial meeting and postministerial meeting, to which the United States, Japan, Canada, Australia and New Zealand are invited, have become important forums for discussing regional political and economic issues. For this reason, Asean members are opposed to the establishment of a secretariat or other administrative groups for a new regional organization. Instead, they believe that their existing organizational structure should be used as the basis for an expanded regional economic entity.

[11] Speech by James Baker, secretary of state, "A New Pacific Partnership: Framework for the Future," before the Asia Society, New York, June 26, 1989.

In an attempt to reassure its Southeast Asian allies, Washington continues to emphasize that Asean is a "pillar of U.S. relations with the Pacific" and is essential to any regional economic grouping. However, one Australian trade official has been quoted as saying that using Asean as a basis for a new regional economic entity would "require significant adaptation to get it up to speed . . . it would take several years to achieve." Coming on the eve of the Canberra meeting, this statement probably heightened Southeast Asian nations' concerns. Surprisingly, when the 12 nations convened November 6 to discuss the prospects for an economic grouping, Asean formally endorsed the concept of a new regional forum. However, by the end of the meetings, Indonesian Foreign Minister Ali Alatas, chairman of the Asean committee on a new regional forum, remained firm that this goal could best be achieved by using the existing Asean structure.

The Canberra Meeting

The economic and foreign ministers who convened in Canberra knew they faced an ambitious agenda if they were to make meaningful headway in charting a course for regional economic cooperation. Key issues facing them included the structure of the organization, its membership and its mission. While it appeared that participants wanted more from this session than empty rhetoric, they also recognized the complexity of bridging some of the political, economic and sociocultural differences that heretofore have impeded cooperation. As one U.S. official remarked, "We are at the beginning of a process that will evolve over five to 10 years."[12]

Structure - There appears to be fairly widespread agreement that private-sponsored or quasigovernmental organizations no longer serve the region's need for greater multilateral interaction on economic issues. However, Asia Pacific nations cannot agree on how the entity should be organized. As discussed above, Asean members fear that establishment of an OECD-like secretariat will subsume their organization. Smaller nations in the region also are worried that a U.S. and/or a Japanese presence in an administrative organ will lead to major power domination of regional affairs.

Other questions include: where should the organization be headquartered and should it be staffed with its own bureaucracy? Would development of a bureaucratic structure impede the sort of flexibility and adaptability that potential participants believe is necessary given the economic dynamism of the Asia Pacific? How effective would be leadership-by-committee, comparable to the arrangement employed by the Group of Seven major industrial nations under which subcabinet-level staff of the various government ministries share responsibility for coordinating the group's activities?

These difficult organizational questions, which could have paralyzed discussions from day one, were not even broached at the Canberra meeting. Gareth Evans, APEC chairman and Australia's minister for foreign affairs and trade, stated at the close of the first meeting that "it was premature at this stage to decide upon a particular structure, either for a ministerial-level forum or its necessary support mechanism." He added that "ideas were evolving" and would be addressed at a follow-up meeting in Singapore sometime in mid-1990. If all goes well, a third session will be held in South Korea in 1991.

[12] S. Karene Witcher and Raphael Pura, "Twelve Asian-Pacific Nations Meet In Australia On Regional Trade Issues," The Wall Street Journal, November 3, 1989.

Membership - Who should be invited to join the regional grouping? Washington has indicated that it would prefer that open-market economies comprise the core of the organization. However, inclusion of Taiwan and Hong Kong -- two of the most vibrant capitalist economies in the region -- would antagonize China, which is also interested in membership as a means of furthering its economic development. But since the entity generally is envisaged as official in nature, how does one include a country with which several of the countries in the region do not enjoy diplomatic relations? This issue, also potentially divisive, was not addressed in Canberra but will have to be tackled in subsequent meetings.

Mission - Should this be a forum for consideration of economic issues alone, or should political and sociocultural matters also be raised? Again, given concerns about Asean's institutional integrity, members of that organization have been adamant that such an entity remain strictly economic in nature. In view of the fact that Prime Minister Hawke initially presented his plan as a "Pacific OECD," it would appear that Australia, too, favors that mission. However, Japan and the United States would like to keep the doors open to consideration of political and other issues, such as the environment. APEC conferees also held off deliberating this question.

What then, if anything, was accomplished in Canberra? In an apparent effort to give APEC some cohesion, purpose and forward momentum, conferees agreed on a "work program" of joint projects of substantive interest to Asia Pacific nations. Among them are studies on the outlook for economic growth in the region, the establishment of a human resources program and cooperative approaches to resolving infrastructure problems. APEC chairman Evans indicated that two projects would be undertaken immediately: one to review data on regional trade in goods, services and capital; the other to examine mechanisms for facilitating trade, investment and technology transfer among Asia Pacific countries. Senior government officials who participated in the APEC meeting also will confer with the "three Chinas" concerning their possible participation at the follow-up gathering next year, the Australian official indicated.

Participants do not appear discouraged by the lack of progress on organizational matters, nor do they appear daunted by the tasks ahead. In summing up the meeting Mr. Evans suggested that conferees accomplished exactly what they had hoped. "What we are doing," he said, "is not so much launching a formal institution as initiating a process."[13]

Washington's New Asian Strategy

Mr. Baker's call for a "new Pacific partnership" has spawned rampant speculation about the nature and the direction of U.S. foreign policy in the coming decade. Some foreign officials have suggested that U.S. interest in Asia Pacific economic cooperation is motivated by American anxieties about a "fortress Europe" when the EC becomes fully integrated in another three years. Commenting on the "heavyweight" U.S. presence at the APEC meeting -- that is, Secretary Baker, U.S. Trade Representative Carla Hills and Commerce Secretary Robert Mosbacher -- one Australian official was quoted as saying that Washington appeared to be sending a subtle message to its European allies that if the

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[13] Keith B. Richburg, "Pacific Rim Nations Tentative on Talks Over Trade Group," The Wall Street Journal, November 7, 1989.

EC closes its doors to foreign commerce, the United States, as a Pacific power, has alternative markets and trading partners.[14] Also implied is that Washington, by playing a leading role in the debate and creation of a new economic grouping, is trying to develop a potential mechanism to use as leverage in bargaining for trade concessions with its Atlantic allies.

Another interpretation of heightened American interest in this region is that Washington, anticipating the economic dynamism of the much-ballyhooed "new Pacific century," gradually is deemphasizing its relations with Europe. Yet another view is that U.S. policymakers regard an Asia Pacific economic grouping as a means of containing further Japanese trade and investment expansion in the region.

Washington has not flatly denied that it is concerned about the implications of a unified EC. At the close of the APEC meeting, USTR Hills commented that the proposed grouping will provide "greater discipline" in the GATT-based international trading system, perhaps suggesting that the impact of the new regional organization will be felt in the Atlantic as well as the Pacific. Also, one of the principles outlined in the Baker initiative is that such an entity must expand trade and investment in accordance with GATT. Moreover, American officials and private-sector participants in PECC and other forums emphasize that they are not trying to affect development of, nor do they see benefits to be derived from, the creation of a closed trading bloc in the Pacific. Mr. Fairbanks has pointed out that the economic, cultural and political diversity of the region prevents any serious effort to form a trading bloc that would rival the EC. "The Pacific nations have already demonstrated with the PECC that their approach to cooperation will be uniquely adapted to the region's special characteristics," he maintains.[15]

Is U.S. foreign policy undergoing a fundamental shift that will deemphasize European ties and place greater emphasis on building relations with this country's Asia Pacific partners? Five years ago then Under Secretary of State Lawrence Eagleburger touched off considerable concern in European capitals by saying that U.S.-European differences over economic and political/security issues were contributing to a "shift in the center of gravity of our foreign policy intention toward the Pacific" (see JEI Report No. 43A, November 9, 1984). The Baker initiative would appear to substantiate this interpretation.

U.S. policymakers reject this line of reasoning. The Eagleburger statement, for one, has been characterized as an individual reaction to problems in communicating with Europe, sometimes referred to as "negotiating fatigue." America's historic ties, attitudes, cultural affinity and orientation toward Europe are likely to remain quite strong no matter what happens in the Asia Pacific, officials say. And recent developments in Eastern Europe and Soviet party leader Mikhail Gorbachev's glasnost initiatives are likely to keep strong U.S.-European ties as a linchpin to America's global security strategy, they add.

Yet, at least one political analyst has proposed that the emphasis of U.S.-European and U.S.-Asian relations may indeed be changing; that is to say, political changes in Europe and arms reductions negotiations will dominate American diplomatic activity in this part of the world, while Asia's rapidly growing economies will increase the importance of trade and investment in U.S. relations toward that region. A Senate aide who has played an active behind-the-scenes role in Congress' consideration of a regional economic grouping has suggested that the growing interest in an Asia Pacific economic organization reflects a general elevation of the economic and social aspects of U.S. foreign policy over the political and military components.

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[14] Ibid.

[15] Fairbanks, op. cit., p. 18.

However, the comprehensive nature of Mr. Baker's "new Pacific partnership" suggests that Washington may be in the midst of reevaluating its overall policy toward the region. Politically and economically, the Asia Pacific has changed dramatically in recent years. American policymakers recognize that U.S. policy toward the region should be adapted to reflect these changes rather than continue statically along the lines adopted during the early postwar years. In Mr. Fairbank's words, "[the United States has] entered a new era in the Pacific that calls for a more complex and subtle leadership role by the United States if we are to maximize our effectiveness." Mr. Baker's "new Pacific partnership" may be Washington's effort to define a subtler leadership role for itself.

Indeed, the secretary of state has urged continued American engagement in the region -- but one that recognizes roles for its increasingly prosperous and stronger allies. Mr. Baker also has encouraged exploration of "creative, new ways to assure our mutual defense." Citing Japan's emergence as a global economic power, Mr. Baker in his Asia Society address reiterated the administration's refrain that Tokyo should be engaged in "more creative sharing of global responsibilities."[16] However, he urged both the United States and Japan to recognize that their expanding relationship will "require a transformation of outlook and policy in both countries."

In this regard it is unlikely that the United States views a regional organization as a means of checking Japan's economic expansion. If anything, Washington may believe that it will be more successful in pushing trade liberalization initiatives with Tokyo in a multilateral forum than in continually contentious bilateral talks. As one PECC participant observed, by enabling several different countries to share experiences and potential solutions -- on market access questions, for example -- multilateral approaches diffuse inherent tensions more readily; rather than two countries squaring off, several countries can develop a broader agenda permitting a balance of interests and concerns.[17]

Outlook

The fact that Washington has directed the energies of three cabinet members toward development of a Pacific Rim regional economic entity is testament to how seriously the United States views economic development in this part of the world. However, aware of the need to develop a new approach toward the Asia Pacific that takes into account many of these countries' economic and political gains, U.S. policymakers have opted for a comparatively low-key leadership role. The United States certainly has made its views known on how it envisages a regional organization, but it is doubtful that this country -- or any other country -- will go out front in advocating a particular plan. A new regional grouping also may proceed slowly in light of destabilizing developments in Eastern Europe that are causing all economic and political entities to undergo self-examination.

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[16] Baker, op. cit.

[17] Fairbanks, op. cit., p. 18.

Given the region's geographic, political, economic and sociocultural diversity, consensus is the operative word. If the very appealing concept of regional economic cooperation is ever to be implemented, all interested parties must reach an agreement on its structure, membership and mission -- three tough issues that to date have proved to be elusive. The upcoming meetings in Singapore and South Korea will reveal the extent to which regional members are willing to subordinate some of their individual interests to realize even greater gains through multilateral cooperation.

For further information, contact Barbara Wanner.

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The views expressed in this report are those of the author and do not necessarily represent those of the Japan Economic Institute.

JEI Report will not be published November 24, 1989 because of the Thanksgiving holiday. The next report will be dated December 1, 1989.

APPENDIX

U.S. Exports to APEC Countries, 1984-88

(in millions of dollars, f.a.s. value basis)

Country	1984	1985	1986	1987	1988
Australia	$4,793	$5,441	$5,551	$5,495	$6,981
Canada	46,524	47,251	45,333	59,814	69,233
Japan	23,575	22,631	28,882	28,249	37,732
New Zealand	708	727	881	819	942
Brunei	34	51	202	93	78
Indonesia	1,216	795	946	767	1,056
Malaysia	1,856	1,539	1,730	1,897	2,139
Philippines	1,766	1,379	1,363	1,599	1,880
Singapore	3,975	3,476	3,380	4,053	5,770
South Korea	5,983	5,956	6,355	8,099	11,290
Thailand	1,113	849	936	1,544	1,964
Total APEC Countries	91,543	90,095	95,559	112,429	139,065
Total U.S. Exports	217,888	213,146	227,159	254,122	322,225

U.S. Imports from APEC Countries, 1984-88

(in millions of dollars, c.i.f. value basis)

Country	1984	1985	1986	1987	1988
Australia	$2,899	$3,069	$2,873	$3,287	$3,856
Canada	66,911	69,427	68,662	71,510	81,434
Japan	60,371	72,380	85,457	88,074	93,168
New Zealand	880	969	1,097	1,180	1,303
Brunei	11	2	64	16	30
Indonesia	5,868	4,933	3,675	3,719	3,494
Malaysia	2,825	2,399	2,534	3,053	3,853
Philippines	2,622	2,334	2,150	2,481	2,906
Singapore	4,121	4,412	4,884	6,395	8,226
South Korea	10,027	10,713	13,497	17,991	21,209
Thailand	1,426	1,543	1,873	2,387	3,424
Total APEC Countries	157,961	172,181	186,766	200,093	222,903
Total U.S. Imports	341,177	361,626	382,295	424,442	459,565

Source: Department of Commerce

U.S. Foreign Direct Investment in APEC Countries, Yearend 1984-1988

(net book value in millions of dollars)

Country	1984	1985	1986	1987	1988
Australia	$8,918	$8,772	$9,340	$11,143	$13,058
Canada	46,730	46,909	50,629	58,377	61,244
Japan	7,936	9,235	11,472	14,671	16,868
New Zealand	510	576	598	732	826
Brunei	1	(*)	-29	-18	-18
Indonesia	4,093	4,475	3,217	3,050	3,006
Malaysia	1,101	1,140	1,021	1,019	1,363
Philippines	1,263	1,032	1,299	1,220	1,305
Singapore	1,932	1,874	2,256	2,462	3,005
South Korea	716	743	782	1,003	1,302
Thailand	1,081	1,074	1,078	1,274	1,126
Total APEC Countries	74,281	75,830	81,663	94,933	103,085
Overall U.S. Foreign Direct Investment	211,480	230,250	259,800	307,983	326,900

(*) Less than $500,000.

Source: Department of Commerce

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JEI

REPORT

A Two-Part Report: A and B

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IN THIS ISSUE:

Japanese Investment Surge Worries Washington 1

Japan Debates Higher Retirement Age 4

Tokyo Ponders East European Reforms 5

U.S. HDTV Picture Still Fuzzy 7

United States, Japan Agree
To Expand Air Service 9

Washington Disappointed
By Slow Pace Of SII Talks 12

Notes: Sino-Japanese Ties;
No Emissions Timetable 13

Japanese Investment Surge Worries Washington

Japan's spending on plant and equipment is high and heading higher. That is the principal finding of two recently released surveys conducted in September, one by the Japanese government and the other by a leading Japanese bank. Both show that a double-digit increase in capital spending is likely during the current fiscal year that ends March 31, 1990, suggesting the investment boom will continue for a third straight year. (For details see JEI Report No. 15A, April 14, 1989.) The increase comes on top of aggregate 1988 plant and equipment spending that, using current exchange rates, was virtually identical to the dollars invested in the much larger U.S. economy.

The Economic Planning Agency reported that the 4,275 firms it surveyed planned to increase spending 17 percent in nominal terms during FY 1989, a figure scarcely resembling the 6 percent year-to-year gain it anticipated in its March survey. The 21.7 percent jump in investment by manufacturing firms exceeded the 14 percent rise among nonmanufacturing concerns. The Industrial Bank of Japan, Ltd. survey, which canvassed 2,891 companies, showed plant and equipment spending by manufacturing firms up 23.9 percent and a 12.3 percent rise among nonmanufacturing businesses. The largest expected gain -- 52.4 percent -- was in the nonelectric machinery industry (see Table).

September 1989 Survey of Planned Plant and Equipment Spending in Japan

	Number of Firms	FY 1988 Actual (billions of yen)	FY 1989 Percent Change
Manufacturing	1,318	Y5,775.5	23.9%
Steel	94	585.7	28.5
Nonferrous Metals	73	266.6	37.1
Electric Machinery	129	1,322.6	29.6
Shipbuilding	16	145.7	11.2
Motor Vehicles	112	825.0	30.0
Nonelectric Machinery	160	238.0	52.4
Oil Refining	48	338.1	21.7
Chemicals	231	780.6	20.3
Textiles	61	281.6	3.0
Pulp and Paper	50	352.3	9.4
Nonmetallic Mineral Products	93	178.2	23.3
Food Products	97	204.6	15.0
Other	154	256.5	-3.4
Nonmanufacturing	1,531	15,464.2	12.3
Mining	37	65.2	-24.1
Gas	48	312.2	15.7
Construction	109	773.3	20.5
Real Estate	196	2,012.0	26.1
Land Transportation	149	1,012.2	14.6
Marine Transportation	119	153.3	3.7
Department Stores and Supermarkets	72	504.7	17.7
Leasing	110	9,538.3	8.9
Other	691	1,093.0	9.4
Electric Utilities	42	3,708.1	3.4
Total	2,891	24,947.8	13.7

Source: Industrial Bank of Japan

These figures, and others like them, have set off alarms in Washington. American officials fear that the high levels of investment imply an increase in production capacity in Japan. This potential, in turn, makes an export surge to the United States more likely. Higher Japanese exports, in the official American view, is about the last thing either the U.S. economy or the bilateral relationship needs. An unnamed Washington source even gave Nihon Keizai Shimbun, the economic daily, a list of specific industries where excess capacity is a potential problem: cars, steel, electronic equipment and ships.

Richard McCormack, undersecretary of state for economic and agricultural affairs, strongly put this position to his Japanese counterparts during the November 3-4 subcabinet-level talks in Washington. As he later elaborated, "The Japanese export machine is already a very large and powerful factor in the world. . . . And if [it] becomes excessively large, this is going to be increasingly difficult for the world to cope with." As a solution, Mr. McCormack recommended increased Japanese public works spending, such as housing, highways and other infrastructure projects.

Tokyo rejected both the analysis of the problem and the suggested remedy. As they have in the past Japanese officials stressed that most capital spending was not directed primarily toward increasing capacity but, in cases where it was, the new capacity would help to meet rising domestic demand. According to EPA, only 30 percent of the projected added investment is aimed at boosting capacity. (However, in at least one industry, Tokyo apparently saw cause for concern. The Ministry of International Trade and Industry reportedly has pressured Mazda Motor Corp., Nissan Motor Co., Ltd. and Honda Motor Co., Ltd. to scale back planned investments in new plants and plant expansion to head off a feared export surge when the plants come on line.) As to public works spending, Japanese representatives at the subcabinet-level talks argued that higher spending would risk higher rates of inflation in Japan. Finance Minister Ryutaro Hashimoto added that Tokyo had no plans to reverse its policy that calls for no new debt-financing government bonds in FY 1990.

In Tokyo's view increasing public works spending would be tantamount to pouring oil on Japan's smoldering inflation problem. Overall wholesale prices through October were running 3.3 percent ahead of a year earlier, below the rate of increase in the United States but higher than recent rates in Japan. However, if public works spending were implemented in conjunction with a tighter monetary policy, the result might be to crowd out some private investment, thus holding in check overall aggregate demand -- and inflationary pressures. The result of this admittedly tricky maneuver would be continued low inflation, less dependence on private investment to sustain the current expansion and less worry from Washington about higher exports, in part because the yen would strengthen in the process.

Of course, the investment surge could sputter and die of its own accord. Some crosscurrents suggest this possibility: even as firms were reporting to EPA their increased investment plans, they were conveying a sense of diminished optimism over their near-term economic prospects. EPA's measure of domestic business confidence, determined by subtracting positive outlooks from negative ones, dropped to a predicted positive 6 for the first three months of 1990 from a positive 13 in the October-December quarter. If such weakness materializes and if, as Nomura Research Institute, Ltd. has found, most of the current plant and equipment surge is closely related to rising levels of profitability in Japanese firms, firms may scale back investment plans.

An apparently similar ill omen revealed by the IBJ survey should be discounted. According to IBJ, in FY 1990 companies expect to decrease their plant and equipment spending 0.3 percent from FY 1989 levels. However, a year ago a similar IBJ survey anticipated that FY 1989 spending would drop 2.3 percent from FY 1988's figure, although companies now say they plan to hike investment 13.7 percent in the fiscal year ending in March. Repeating a pattern seen in previous years, firms have tended to be initially conservative in their long-term forecasts of investment spending but increasingly upbeat immediately prior to and during the forecast period. Should FY 1990 spending plans eventually be revised upward comparable to past amounts, firms may find that Washington's rhetoric on the subject heats up as well.

Douglas Ostrom

Japan Debates Higher Retirement Age

Encouraged by the increasing number of companies that have instituted age 60 as the retirement threshold, the Ministry of Labor is making plans to cope with the aging Japanese work force by pushing firms to keep people working until 65. Perhaps more controversial is an accompanying MOL proposal to penalize companies that require retirement before age 60. That age has been the officially recommended retirement target since a 1986 law was enacted to stabilize employment conditions for older workers. Both businesses and trade unions since then have cooperated to fulfill the sense of the law. As a result of their efforts, the proportion of companies requiring retirement at 60 compared with all firms that have an age-based retirement system reached 55 percent in 1988; 12 years earlier the comparable figure was 32.3 percent. The increase comes mainly from the significant improvements made by big businesses -- companies employing 5,000 or more workers. Compliance with an age 60 retirement system in this group catapulted from 18.2 percent in 1976 to 82.4 percent in 1988.

MOL's new proposal basically addresses two concerns. Demographic changes indicate that the percentage of the population aged 55 to 64 compared to the total working-age population (people between 15 and 64) will jump from 15 percent in 1985 to 22.1 percent in 2010. Given fears of a labor shortage and other reasons, MOL figures it is important to arrange work opportunities for older people. Unemployed older workers now have much difficulty finding a job; the effective job opening ratio is only 0.24 for workers over the age of 55 in spite of Japan's current solid economic growth. (In contrast, the ratio for workers age 30 to 34 is 2.11.)

The second rationale for boosting the retirement age is to keep in step with an expected change in the age at which people start receiving social security. MOL is concerned that the rapid increase in the number of workers eligible for social security eventually could bankrupt the system. Currently, different retiree-benefit systems exist in Japan for self-employed people, workers in companies with five or more employees and government employees; the two latter plans require beneficiaries to be only 60 to get pensions. The government decided in February 1984 to integrate the three systems into one universal system in 1995 and to set 65 instead of 60 as the age at which beneficiaries could begin to draw social security. The plan to postpone retirement until 65 will guarantee workers some income until they reach that age when social security payments start, MOL thinks.

Nikkeiren (the Japan Federation of Employers' Associations) opposes the idea of legislating a higher retirement age. The group thinks employers should have the freedom to arrange employment opportunities for older workers instead of being under legal constraints to do so, according to an interim report published October 24 by Nikkeiren's study group on aging. The federation believes that short-term, flexible reemployment measures would be the best means to employ older workers rather than retaining them until they reach a legally set retirement age. In particular, it has said the MOL initiative is unrealistic since the target retirement age does not take into consideration a company's size; it also criticized the plan to penalize companies that cannot meet the target. Although 82.4 percent of all large companies have adopted a retirement age of 60, only 52.7 percent of medium-sized companies (those with 100 to 299 employees) have adopted the same retirement policy. Therefore, significant repercussions among small and midsized companies are expected from a rise in the retirement age and the threatened penalty. Trade unions, however, are jubilant over the MOL idea because they have strongly advocated introducing a penalty along with the extension of the retirement age and have pressured MOL to take legislative action on this.

In the last decade MOL has crafted various policies to increase employment opportunities for older workers, such as offering consulting services and financial subsidies to companies that employ older workers. In FY 1990, when employment opportunities for older workers will be its top priority, MOL will extend new subsidies that provide at most Y10 million ($71,400 at Y140=$1.00) to any company that creates a new continuous employment system, either by increasing its retirement age, reemploying retired workers or providing ongoing work in some form for older workers. Firms also can get a subsidy from MOL if employees over the age of 60 make up more than 4 percent of their work force. MOL will continue its consulting or advisory services as well as establish an organization to provide employment information for those over age 60. It also plans to map out a long-term strategy to deal with the employment challenges of older workers. Although encouraging the age 65 extension, MOL has set 1994 as the target year for full compliance with an age 60 retirement policy by the business community.

MOL expects the Council on Employment, an official advisory group, to issue a recommendation by yearend on its proposal to increase the retirement age to 65. If its plan goes according to schedule, an amendment to the current law governing employment conditions for older workers will be introduced to the Diet next spring. However, it is uncertain whether the council can reconcile the divergent interests of trade unions and small or medium-sized companies and be able to submit a workable recommendation by the end of this year. There are strong indications that neither side will agree to a compromise in the council. If both positions are treated equally in the advisory council's report, the final decision on when and how to increase the retirement age will be in the hands of the Labor Ministry.

Hideo Takahashi

Tokyo Ponders East European Reforms

To encourage democratic reforms in Eastern Europe Tokyo is planning to announce a new foreign aid package for Poland and Hungary. The Ministry of Foreign Affairs expects to draw the funding from the FY 1989 supplemental budget, but that budget probably will not be put together until early 1990. Although some analysts have speculated that Tokyo will make an aid commitment during the late November meeting of the Group of 24 countries gathering to discuss aid to Eastern Europe, Foreign Ministry officials were uncertain at JEI press time about an official announcement date and the amount of aid that will be given. The G-24 aid plan includes a proposed $1 billion package for Poland; Japan is expected to make a commitment similar to Washington's $200 million pledge.

Indicating a thaw in Japan-Eastern Bloc relations as a result of recent events, Prime Minister Toshiki Kaifu has said he hopes to visit Eastern Europe in January. "[Japan] has maintained ties with Eastern European countries as much as possible despite the Iron Curtain," he said, adding "Japan will cooperate [with East European countries] for peace and stability of the world if East European countries make requests [to Japan]."

While many Japanese support the prime minister's plan, not all believe it is a good idea for him to go to Eastern Europe early next year. Within the ruling Liberal Democratic Party former Prime Minister Yasuhiro Nakasone's faction reportedly is against the timing of the visit and believes that Mr. Kaifu instead should focus on problems at home and rally support for the LDP before the upcoming lower house elections. Some Foreign Ministry officials also reportedly do not support a Kaifu visit to Eastern Europe, fearing a poor reception there if Tokyo cannot come up with the amount of aid those countries desire.

Japan has proposed assisting Poland and Hungary with grants, of which approximately half will be for food aid to Poland. The other half is expected to boost worker training and environmental safeguards in the two countries. These grants will be a first for Tokyo. Until now the six East European members of the Warsaw Pact -- Bulgaria, Czechoslovakia, East Germany, Hungary, Poland and Romania -- have not received any financial assistance from Japan that qualifies as official development assistance because of their political alignment. The money they have received to date from the government falls under the heading of other official flows and consists of Export-Import Bank of Japan export credits, import credits, overseas investment credits and direct lending.

By the end of March 1989 the Ex-Im Bank had made credit commitments totaling Y128.3 billion ($916.4 million at Y140=$1.00) to Poland, mainly in the form of export credits (see Tables 1 and 2). While new commitments for Poland apparently are not in the works because of that country's shaky financial position, Hungary, where Ex-Im Bank's financial exposure is limited, is in line for more money. At the end of October Hungarian officials announced that the

Table 1: Export-Import Bank of Japan's March 31, 1989 Credit Commitments to Eastern Europe

(in millions of dollars*)

Country	Direct Loans	Other Credits**	Total
Bulgaria	$219.3	$263.6	$482.1
Czechoslovakia	7.1	227.9	235.0
East Germany	860.0	472.9	1,332.1
Hungary	44.3	20.0	64.3
Poland	140.0	777.1	916.4
Romania	10.0	400.0	410.0

*Converted using an exchange rate of Y140=$1.00.
**Export credits, import credits and overseas investment credits.

Source: Export-Import Bank of Japan

Table 2: Export-Import Bank of Japan's FY 1988 Credit Commitments to Eastern Europe*

(in millions of dollars**)

Country	Direct Loans	Other Credits***	Total
Bulgaria	$55.4	$6.2	$61.6
Czechoslovakia		2.3	2.3
East Germany	---	---	---
Hungary	---	3.9	3.9
Poland	---	---	---
Romania	---	---	---

*Credit commitments do not include commitments for cofinancing by Japanese commercial banks.
**Converted using FY 1988's average exchange rate of Y128.26=$1.00.
***Export credits, import credits and overseas investment credits.

Source: Export-Import Bank of Japan

country would receive an Ex-Im Bank credit line of Y5 billion ($35.7 million) in response to democratic reforms. The money will be used to assist in economic restructuring.

Political analysts speculate that Japan will be cautious about promising grants and/or other forms of official development assistance to East Germany until the political situation there becomes more certain. The same conclusion also seems to apply to the Em-Im Bank, although the bank's hesitancy might reflect the fact that East Germany accounted for 38.7 percent of all its Eastern European credit commitments as of March 1989 and that most of the East German money was in the form of direct loans.

Despite its creditor status in Eastern Europe, Japan does not have strong trade ties there (see JEI Report No. 42B, November 3, 1989). The government's interest in providing economic assistance to the region appears to be a result of its responsibilities as one of the world's largest aid donors. As a world economic power Tokyo also has indicated that it feels compelled to support Eastern European moves toward democracy by providing whatever assistance it can.

Gretchen Green

U.S. HDTV Picture Still Fuzzy

While Japanese companies press their lead in the commercialization of high-definition television, the debate continues over the U.S. government's role in developing a domestic HDTV industry. Many in Congress advocate limited government funding and exemptions to certain antitrust provisions to entice domestic firms to jump into the market. But the administration is torn between its free-market philosophy and its commitment to a strong national defense, which increasingly relies on aspects of HDTV technology.

Discussions between major Japanese and American electronic component makers could add more confusion to the U.S. HDTV debate. The Electronics Industry Association of Japan proposed in June the formation of a joint venture with the U.S. Semiconductor Industry Association to develop and produce chips for HDTV. At a November 8 follow-up meeting EIAJ and SIA agreed to share technical information and develop critical HDTV logic circuits. (It is not clear if the agreement includes advanced memory chip technology, another subject of bilateral friction.) A 20-person team (10 from each country) will be selected by Matsushita Electric Industrial Co., Ltd., American Telephone and Telegraph Co. and LSI Logic Inc. to lead the project.

The joint venture has generated disparate views on its impact. American semiconductor makers see it as a chance to quickly match the technical advantage of Japanese electronics producers who have spent many years developing a working HDTV system. Potential American producers of HDTV equipment, however, worry that the alliance of U.S. chip makers and Japanese equipment producers will make it impossible to insulate the nascent U.S. HDTV market from overwhelming foreign competition. Boosters of efforts to develop a domestic HDTV industry and domestic HDTV standards also see it as a serious blow to their hopes. SIA, however, insists that the agreement has nothing to do with standards. On the contrary, the association argues, the U.S. industry will gain valuable knowledge that can be used to develop an entirely different HDTV standard as well as a wide range of related areas. While the agreement does not include any Japanese commitment to buy U.S. chips, American producers expect it to lead eventually to greater exports to Japan, further easing bilateral tensions.

Another area of concern centers on the technical standards for HDTV, which will have a major impact on manufacturers, broadcasters and users. (For an in-depth discussion, see JEI Report No. 2A, January 13, 1989.) After initially acquiescing to Japan's system, the United States withdrew its support for a single worldwide standard. At the recently concluded International Radio Consultative Committee meeting participants from 36 nations agreed on 23 global standards relating to HDTV. Agreement on four critical items, however, still must be ironed out. The likely outcome of the talks is to set general standards that will allow Japan, the United States and Western Europe to adopt their own systems. Some U.S. observers even see Sony Corp.'s purchase of Columbia Pictures Entertainment Inc. as a threat to U.S. efforts to develop a domestic HDTV industry since Sony could issue Columbia's huge film library in only the Japanese HDTV format, setting a de facto standard in the United States.

Jon Choy

United States, Japan Agree To Expand Air Service

After 13 years of protracted discussions U.S. and Japanese negotiators concluded an agreement in Tokyo November 5 that will expand by 30 percent air passenger and cargo services between the two countries. "This agreement represents the most dramatic expansion of air services to Japan since the original bilateral aviation agreement was signed in 1952," said Secretary of Transportation Samuel Skinner. Concluded as a memorandum of understanding between the United States and Japan, the new accord builds on the 1985 interim aviation agreement as part of an ongoing, comprehensive effort by both governments to completely revamp the basic 1952 treaty (see JEI Report No. 13A, April 1, 1988).

Both American and Japanese carriers have been clamoring for expanded rights to serve the increasingly lucrative transpacific market. The November 5 agreement authorizes many new routes for combined passenger and cargo services between the two countries. Increased all-cargo flights also will be permitted. In addition, special provisions are aimed at benefiting air traffic to Alaska, Guam and Saipan. The terms of the accord address the following issues:

- Capacity restrictions - U.S. airlines will be able to operate new nonstop combination services to Tokyo from three American cities; they also will be able to provide these services to three non-Tokyo/Osaka cities from three U.S. cities. (The 1985 accord already had allowed three additional Pacific routes for nonstop combination service by existing or new carriers of both countries; route options at that time were confined to Tokyo-Honolulu, Nagoya-Honolulu, Tokyo-Los Angeles, Tokyo-Portland or two new U.S. destinations from Tokyo.) American carriers currently providing passenger and/or combination services in the U.S.-Japan aviation market are: United Airlines, Northwest Airlines, Continental Air Lines, Delta Air Lines and American Airlines. Gateways for Japan-bound U.S. carriers are: Chicago, Dallas/Fort Worth, Honolulu, Los Angeles, New York, Portland, San Francisco and Seattle.

Comparable expansion open to Japanese carriers serving the transpacific market -- Japan Airlines and All Nippon Airways -- will enable nonstop combination services from Tokyo to three U.S. cities and from non-Tokyo/Osaka cities to three American cities. Japanese airlines currently offer nonstop flights to: Anchorage, Atlanta, Chicago, Honolulu, Los Angeles, New York, San Francisco, Seattle and Washington, D.C. In addition, Japanese airlines will be permitted to offer one-stop service to as many as three other U.S. cities. (American carriers have no restrictions on connections within their home market.)

Japan Airlines, in particular, will see its service in the Tokyo-Seattle-Chicago market expand from five to seven flights per week. The new accord also may enable Japan Air System (formerly Toa Domestic Airlines) to inaugurate regularly scheduled service on the Japan-U.S. route.

- Cargo service - Washington will be able to designate an additional all-cargo carrier to serve the U.S.-Japan market. Federal Express Corp. and Northwest Airlines currently are the only American air freight operations serving Japan. Under the new agreement either Federal Express or Northwest also will be authorized to serve an additional point in Japan to be selected from Nagoya, Fukuoka or Sapporo.

JAL and Nippon Cargo Airlines, the two Japanese carriers flying freighters to the United States, will be authorized to operate up to eight all-cargo flights per week to Chicago, a U.S. destination long coveted by JAL. Japanese authorities probably will divide this allotment between the two airlines. The November 5 MOU also will enable NCA to inaugurate new cargo service to Los Angeles. Under the 1985 agreement NCA, Japan's first international all-cargo airline, began offering six round-trip, all-cargo flights a week between Tokyo and New York via San Francisco.

The November 5 agreement also addressed a longstanding complaint by Flying Tiger Line, Inc., which this past summer was acquired by Federal Express. Flying Tiger in August 1988 charged that Japan was unfairly limiting its right to ship cargo "beyond" Japan to Europe via Anchorage, Alaska. Japanese authorities had insisted that the volume of freight traffic between Tokyo and Europe could not exceed the volume on the Tokyo-Anchorage route.

To avoid imposition of U.S. sanctions, Tokyo subsequently agreed to authorize unrestricted all-cargo service on the Tokyo-Alaska-Europe route for a 179-day trial period providing it would be allowed to check freight records. However, Japanese authorities subsequently imposed a rule that half the contents of polar flights to Europe via Alaska had to be destined for the U.S. market. When this "50-50" rule was applied to each flight, it meant that in some cases packages had to be left behind if the load was heavy on a particular flight with packages to one or the other destination.

On this point, Tokyo decided to bend. Although Japanese authorities still will monitor the volume of "beyond" freight to Europe, the 50-50 rule will apply on the basis of a year's record rather than on each flight.

- Charter restrictions - The limit of 300 U.S. charter flights to Japan per year will be increased to 450 flights annually, effective January 1, 1990. This provision appears to represent a U.S. concession in that Washington repeatedly has called for the elimination of this quota system for charter flights, contending since 1978 that the market should make this determination.

- Guam/Saipan service - Washington will be able to designate an additional carrier (for a total of two) to fly Guam/Saipan to Nagoya, Fukuoka and Naha (Okinawa). In addition, two new flights will be permitted between Guam and Saipan to connect with Japanese cities other than those already served. Continental's subsidiary, Air Micronesia, currently is the only U.S. carrier serving these routes.

- Alaska service - Any U.S. or Japanese airline providing combination service will be permitted to serve Alaska en route. Moreover, one additional U.S. carrier and a Japanese carrier will be authorized to provide daily combination service between Alaska and any point in Japan other than Tokyo or Osaka.

Jeffrey Shane, assistant secretary of transportation for policy and international affairs, said given the ever-expanding demand for transpacific service (see Table), both sides would have preferred even broader opportunities. Unfortunately, restrictions at Narita International Airport in Tokyo and at Osaka International Airport limited the options. "[The November 5 agreement] reflects a balance of aspirations," the assistant secretary stated. "This is certainly less than what we hoped we could get. And the Japanese feel the same way. But that's good because both sides remain hungry."

The American airlines that will provide the expanded service and the new gateway cities will be selected by the Department of Transportation after a formal review of applications from interested parties. The ink on the accord had barely dried November 6 when United and American filed with DOT for authority to begin nonstop service on the Chicago-Tokyo route, which currently is served by Northwest and JAL. American also is considering applying for flights out of Los Angeles and reportedly has ordered eight new McDonnell Douglas Corp. jumbo jets in anticipation of expanded transpacific service.

Moreover, several American cities that hope to realize a boost in revenues as a result of expanded air traffic with Japan -- including Houston, Phoenix, Denver, New Orleans, Orlando and San Jose -- reportedly have been lobbying the airlines to chose them as new gateways to Japan. But, despite the widespread enthusiasm of American carriers and potential for new gateways to tap

International Scheduled Passenger Traffic To and From Japan

(in millions)

		Base Year Traffic		Forecast Traffic Volumes		Projected Annual Growth Rate
Region	Countries Covered	1988	1989	1989	1993	1989-93
Central America	1	17.6	2.7%	18.1	16.9	-0.9%
Europe	11	1,903.1	14.6	2,181.1	2,982.1	9.4
Indian Subcontinent	3	142.1	8.1	153.7	181.6	5.0
Lower South America	6	76.3	18.2	90.2	152.7	14.9
Middle East	6	69.0	8.1	74.6	97.3	7.1
North America	2	6,868.9	14.5	7,862.5	10,260.3	8.4
Northeast Asia	4	9,590.5	13.4	10,873.1	15,278.0	9.8
Southeast Asia	5	2,873.3	17.2	3,366.8	5,107.8	12.2
Southwest Asia	4	2,076.3	18.3	2,455.3	3,693.2	12.2
Total	37	23,617.3	14.6	27,075.3	37,769.9	9.8

Source: International Air Transport Association

into this market, it appears that patience may be in order. According to Mr. Shane, his department will not decide how to allocate the new routes until October 1990.

Barbara Wanner

Washington Disappointed By Slow Pace Of SII Talks

Are the Structural Impediments Initiative talks doomed? That view, offered by a cross section of analysts after Japan and the United States agreed last summer to tackle the underlying macroeconomic and microeconomic causes of the chronic $50 billion-plus bilateral trade imbalance, has become more prevalent in Washington following a second round of discussions in early November. But writing SII off on the basis of two sessions would be premature. What the Japanese delegation said or did not say at the November 6-7 meetings obviously matters. Far more important, though, is what is happening behind-the-scenes in Tokyo, and developments there provide some grounds for optimism about the outcome of the SII talks.

American trade policymakers knew their latest strategy for narrowing the huge U.S.-Japan trade gap was extremely risky because of the short time Tokyo had to demonstrate progress on problems that realistically can be resolved only over the long run. The Bush administration also recognized that the precarious position of the ruling Liberal Democratic Party made SII an even longer shot. Nevertheless, senior officials were confident that Tokyo understood what was riding on the talks and that it would give the White House enough ammunition to

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JAPAN'S SATELLITE DEVELOPMENT PROGRAM REVISITED

Summary

The Bush administration's May 1989 decision to go after Tokyo's satellite procurement policy under the Super 301 provision of the 1988 trade act caught many analysts off guard. True, the de facto ban on public-sector purchases of foreign spacecraft made satellites an obvious candidate. These observers figured, however, that a combination of factors, including the opening of the domestic satellite communications services market to two businesses using American-made equipment, would keep satellites off the final list of priority Japanese trade practices. What they overlooked was the concern among U.S. trade policymakers that Japan is using a protected government market to develop a commercial satellite industry.

Government and industry officials in Japan deny that the country's satellite development program is commercially oriented. But their disclaimers -- which cover work on communications satellites, the area of greatest concern in Washington -- have fallen on deaf ears. Questions about the ability of Japanese companies to bridge a significant technology gap in communications satellites also do not appear to faze American officials convinced that Tokyo's development strategy will enable Japanese competitors to challenge U.S. leadership in yet another industry. Perhaps the only way Tokyo can appease American critics is to abandon plans, now in the formative stage, to design and build a new generation of communications satellites for launch around 1995.

Japan Economic Institute 1000 Connecticut Avenue, N.W., Washington, D.C. 20036 202·296·5633

New Challenge to Japan's Satellite Program

Supercomputers and wood, two of the products cited by the Bush administration when it singled out Japan under the Super 301 provision of the 1988 Omnibus Trade and Competitiveness Act, were odds-on favorites in the Washington trade community for priority designation (see JEI Report No. 17A, April 28, 1989). To the surprise of many analysts, however, the White House's list of negotiating targets also included a long shot, satellites and the prohibition on the procurement of foreign spacecraft by Japanese government agencies.

The Japanese government's exclusionary purchasing regulations for satellites -- whether communications, broadcast, weather or earth observation -- unquestionably passed the statutory trade barrier test, but it was not clear that satellites met Super 301's export potential criteria since Tokyo's spacecraft requirements, restricted to nonmilitary uses, are limited. Administration watchers also doubted that the White House would go after Japan's de facto ban on public-sector procurement of foreign satellites without the active backing of U.S. satellite builders. Odds makers wondered as well whether the United States was willing to tackle Tokyo's satellite policies when it is counting on Japanese support, both financial and technical, for the manned space station program and other space projects of mutual benefit and on data from Japanese remote-sensing satellites.

What really made satellites a long shot Super 301 choice for most analysts, however, was the end to Tokyo's prohibition on sales of foreign satellites to Japan's private sector. After the domestic telecommunications market was deregulated in April 1985, the Ministry of Posts and Telecommunications licensed two joint ventures to provide commercial satellite communications services. Both companies -- Japan Communications Satellite Co., Inc., a partnership of C. Itoh & Co., Ltd. (40 percent), Mitsui & Co., Ltd. (30 percent) and Hughes Communications Inc. (30 percent), and Space Communications Corp., a Mitsubishi Group venture led by Mitsubishi Corp. (26.05 percent) and Mitsubishi Electric Corp. (20.45 percent) -- contracted for American-built spacecraft and foreign launch services. JCSAT 1, a Hughes Aircraft Co. HS-393 satellite, was launched in March 1989; the identical JCSAT 2 currently is expected to go up in early December. One of SCC's pair of satellites, Superbirds manufactured by Ford Aerospace Corp., was launched last June; its twin was set for a December launch but that date was postponed recently.

To many observers the sale of four American satellites to private Japanese operators was reason enough to leave this product off the final Super 301 list, but the arrival of commercial satellite communications services in Japan seemed to offer another reason not to make satellites a negotiating priority. In February 1989 Nippon Telegraph and Telephone Corp., potentially the biggest satellite customer in Japan, contracted to lease 13 of the 64 transponders (a satellite's receive-retransmit link) available on the two JCSAT satellites. The company, which until now has had to share space on a small, domestically built communications satellite with government agencies and private users, also has agreed to lease Superbird transponders. These moves, analysts thought, at least indirectly undermined a key part of Washington's complaint about Japan's

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public-sector satellite procurement policy -- that NTT, although privatized in April 1985, is not free to buy foreign spacecraft until the government becomes a minority stockholder in 1991 or 1992.

U.S. trade policymakers no doubt weighed these arguments in deciding whether to target satellites under Super 301. In the end the case against priority designation was no match for Washington's broader concerns about the thrust of Tokyo's policy for communications and other types of applications satellites. Like their Reagan administration counterparts, who challenged Japan's satellite procurement practices in 1983 and 1984, current officials in the Department of Commerce and the Office of the U.S. Trade Representative look at the trappings of Japan's satellite policy and see a clear-cut government effort to nurture a domestic satellite industry. For them the signs of industrial targeting are everywhere: prohibition on sales of foreign satellites to public-sector organizations, government funding for industry's research and development work, corporate collaboration on satellite projects, the required selection of Japanese manufacturers as prime contractors and the substitution of local for foreign content in Japan's satellites. From this perspective the Super 301 mechanism offered Washington a unique opportunity to head off the emergence of a rival to the U.S. satellite industry, the world leader in spacecraft hardware and software.

The Japanese government has no real quarrel with Washington's description of the direction of Tokyo's satellite policy. Development of independent technological capabilities in spacecraft design and production was implicit in the government's first statement of space policy, issued in March 1978. This theme also ran through a February 1984 policy update and the June 1989 revision of the Fundamental Guidelines of Space Policy. Government representatives, however, take strong exception to the argument that the goal of autonomous development is motivated by a commercial rationale. Japan must have an independent foundation in space technologies if it is to collaborate with the United States and other countries on the manned space station and related space research, they maintain. And the only way Japan can gain the necessary technical expertise is through a national space development program.

Buttressing their statement that Tokyo's satellite policy is not commercially driven, officials point to the lead that American companies have in spacecraft technologies and the limited financing available in Japan for technical development. At Y155 billion ($1.1 billion at Y140=$1.00) in FY 1989, projected Japanese government funding of space activities is a fraction of U.S. spending, which amounted to roughly $25 billion in FY 1988 for both civilian and military programs or close to $10 billion excluding the Department of Defense's space budget. Moreover, Japan's recent space budgets have been skewed toward funding for the next-generation H-II launch vehicle and for the space station and related space experiments at the expense, if only partial, of satellite development. Budgetary pressures, in fact, forced the government to shift the bulk of the financing responsibilities for the second- and the third-generation Japanese communications and broadcast satellites to the primary users.

This line of argument obviously has not persuaded trade officials in Washington that Japan's program is research oriented. But is the administration's skepticism justified? Does the United States have legitimate cause for concern about the development of an internationally competitive Japanese satellite industry or are officials simply extrapolating from Japan's success in other high technology fields and assuming that satellite manufacturers will duplicate those achievements?

Japan's three satellite builders unquestionably have made considerable technical headway in the 1980s, but their current systems are not state of the art, particularly the communications satellites. Whether this gap is technological or just a function of the limited payload lift capacity of Japan's present H-I launch vehicle is not clear. That uncertainty should be eliminated when the H-II launch vehicle goes into operation, now expected to be 1994 at the earliest. But even if Japan's industry proves capable of incorporating world-class technology in its satellites, there is no guarantee that the spacecraft will be cost-competitive since satellite manufacturers do not have the big domestic market that helped companies in other industries become international competitors.

Trying to Catch Up

Responsibility for space development work in Japan is divided between two primary organizations. The Ministry of Education's Institute of Space and Astronautical Science is in charge of activities in the scientific field, including the development of scientific satellites and the vehicles to launch them. Its spacecraft are built by NEC Corp. and sent into orbit aboard launch vehicles manufactured by Nissan Motor Co., Ltd. from the ISAS Kagoshima Space Center on the southern tip of Kyushu.

R&D work on communications, broadcast, weather and earth observation satellites is coordinated by the National Space Development Agency. This organization, which falls primarily under the jurisdiction of the Science and Technology Agency, also oversees development of launch vehicles for applications satellites and conducts launches from its Tanegashima Space Center on the small southern island of the same name. Prime contractors for NASDA spacecraft are Mitsubishi Electric (communications satellites and the next-generation earth observation satellite), NEC (all weather satellites, the current pair of earth observation satellites and the next-generation broadcast satellite) and Toshiba Corp. (the first two series of broadcast satellites and the next test satellite). Mitsubishi Heavy Industries, Ltd. is responsible for vehicle integration of NASDA's rockets, now in the third generation.

Since Japan's first satellite was sent into orbit in 1970 NASDA and ISAS have launched 43 spacecraft, 39 of them successfully (see Appendices 1 and 2). ISAS has put up 18 scientific satellites whose payloads have evolved from relatively simple ones to sophisticated systems. In the process the institute's three-stage M rocket, now in the fifth generation, has established a track record as a low-cost, reliable vehicle for launching up to 770-kilogram scientific payloads into low earth orbit. In the applications area NASDA's 21 successfully orbited satellites (which include three launched by the United States) also have been marked by steady technological advancement. The same is true of its series of three-stage launch vehicles, with the current H-I capable of lifting 550-kg payloads into hard-to-achieve geostationary orbit.

This technological progress in scientific and applications satellites and launch vehicles has been the product of two different blueprints. From the start ISAS went the independent technology development route. NASDA, in contrast, adopted a development strategy that has proved highly efficient in a number of other Japanese industries. It involved teaming up Japanese manufacturers with more experienced American aerospace companies to acquire technologies that otherwise would be too expensive and time-consuming for domestic industry to develop from scratch -- a process facilitated by the technology transfer provisions of the 1969 U.S.-Japan space cooperation agreement. At the same time NASDA funded R&D work in areas where Japanese firms already had a technical foundation, especially in electronics fields.

Measured solely by the high domestic content of Japan's current or next series of communications, broadcast and earth observation satellites, NASDA's parallel development strategy has worked. But this method of playing catch-up has had a number of drawbacks. For one, continued dependence on American technology for critical subsystems or parts has caused difficulties when NASDA satellites experience operational problems because Japanese engineers do not have access to the malfunctioning foreign parts. Perhaps more important in the Super 301 context, NASDA's drive to replace imported expertise with domestically developed technology generally has meant technically dated equipment that is more expensive to boot than satellites purchased off-the-shelf from U.S. manufacturers. That certainly is true for the country's communications satellites.

Communications Satellites - Japan's first two communications satellites intended for operational service were launched in 1983. The CS-2 spacecraft were built by the Mitsubishi Electric-Ford Aerospace team, the same companies responsible for the experimental CS satellite launched in 1977. The CS-2 and CS shared a common, FAC-supplied basic design. This design, however, was modified by the partners to reflect some of the advances in satellite technology since the CS was planned and to incorporate special features sought by NTT, which covered 60 percent of program costs.

Even with these changes, the CS-2 satellites were far less sophisticated in terms of capacity and variety of services than the communications satellites then in use in the United States and Europe. And they cost more -- about Y49.2 billion ($351.4 million), including launch, tracking and control expenses. To some extent, however, the cost differential was an inevitable by-product of NTT's goal of developing the world's first satellites to use the high-capacity 30/20-gigahertz (Ka) frequency band instead of the 14/11-Ghz (Ku) band used by the United States and Europe for communications satellites. The capacity/service gap was likewise partly intentional. The CS-2s were developed to give NTT, the National Police Agency and other public organizations telephone links between Japan's main and outlying islands and channels for nationwide emergency communications rather than to enable NTT to offer commercial voice, television and high-speed data transmission services.

In fact, capacity and cost considerations on the CS-2 project took a back seat to acquiring communications satellite product and process technologies. Given this primary objective, the program was a success. Mitsubishi Electric and its Japanese subcontractors gained some much-needed design experience working on the CS-2 spacecraft; so did NTT, which was in charge of the communications antennas and the transponders. The program also allowed Japanese companies to gain the skills to manufacture key subsystems for the communications payload since MELCO built the antennas and NEC made the transponders.

Even more valuable was the expertise Mitsubishi Electric acquired in systems integration. Ford Aerospace assembled the first CS-2 satellite at its Palo Alto, California facilities. In addition, it did the integration work, verifying all the system's interfaces, particularly the electrical connections. The U.S. subcontractor also performed the environmental tests, which establish that the satellite should survive and work under the harsh conditions to which it is likely to be exposed during launch and on station. On the second CS-2 satellite, however, prime contractor MELCO performed these three critical jobs with Ford Aerospace's assistance. This transfer of responsibility helped to raise the domestic content of the two CS-2 satellites to 38 percent compared with the 24 percent figure for the CS.

Mitsubishi Electric's work on the CS-2 series gave NASDA the confidence to make the company the prime contractor in practice as well as in name on the follow-up CS-3 communications satellites. Giving MELCO design authority in addition to AIT (assembly, integration and test) responsibility was not as risky as first might appear. From the start the space agency envisioned the project as a way for Japanese suppliers to achieve another incremental increase in satellite design and manufacturing skills, not as an effort to bridge the international technology gap in one leap. Moreover, NTT, which put up close to 70 percent of the funding for the two CS-3 satellites, was involved in the design work, and MELCO engineers were backstopped by their Ford Aerospace counterparts.

NASDA's modest program goals for the CS-3 spacecraft, launched in February and September of last year, were achieved. The communications capacity of each of the satellites was upped to 6,000 telephone circuits from 4,000 apiece on the CS-2, in part through improvements in the NEC-built transponders but mainly because each unit has more transponders -- 15 in the Ka band (including five spares) and three in the C band (one spare) versus the CS-2's six Ka-band and three C-band (one backup) transponders. Moreover, all of the transponders are operable 24 hours a day year-round. On the CS-2 only two transponders operated full-time because of the satellite's limited battery capacity, but that constraint was eliminated on the current series through the use of gallium-arsenide solar cells, a first for communications satellites. In addition, the CS-3's designed service life is seven years compared to five for its predecessor since it carries more fuel for maneuvering.

Despite these advances, the CS-3 does not stack up well against current-generation U.S.-built communications satellites -- a fact driven home when Japan's privately operated communications satellites went into service earlier this year. For example, each of the 24 primary and eight backup Ku-band transponders on JCSAT 1 can relay more than 250 full-duplex telephone circuits or transmit one high-quality television channel or a 45-megabit data stream. Superbird A, which has 10 Ka-band and 19 Ku-band transponders (including a total of seven spares), offers a similar communications capacity. Moreover, both the JCSAT and the Superbird satellites have an expected service life of 10 years.

The CS-3 also comes up short on the cost side. The pair of satellites cost approximately Y66.3 billion ($473.6 million) to build and launch. Japan Satellite Communications paid between $300 and $400 million for its two Hughes Aircraft satellites -- a figure that includes not only launch expenses but also ground tracking and control equipment, while Space Communications reportedly spent $200 million for its pair of Ford Aerospace satellites. But, as in the case of NASDA's earlier communications satellite project, the technical advancement of Mitsubishi Electric and its Japanese subcontractors took priority over cost considerations and capacity requirements, which were limited mainly to the continuation of the CS-2's public communications services and the provision of some circuits for use by the business community. From NASDA's perspective the number that really mattered was the 80 percent domestic content of the CS-3 satellites.

Broadcast Satellites - While the development of domestic technologies was NASDA's paramount objective from the start in communications satellites, the space agency initially took a different tack in its broadcast satellite program. Swayed by the nation's public broadcasting corporation (NHK), which financed 60 percent of the Y58.3 billion ($416.4 million) cost of the BS-2 project, NASDA put state-of-the-art equipment ahead of improvements in Japanese design and manufacturing capabilities. As a result, Japan was the first country in the world with a nationwide direct broadcast satellite system. But NHK's attempt to provide television service to mountainous areas and remote islands and eliminate reception problems in congested urban environments through DBS transmission proved to be an uphill, expensive battle.

Two of the three transponders on the first BS-2 failed within four months of the satellite's January 1984 launch. Those failures limited NHK to one DBS channel instead of the pair it had planned to use. They also delayed the launch of the backup BS-2 satellite until February 1986 as engineers tested the unit's modified transponders. But NHK's troubles still were not over; the second BS-2 developed problems, subsequently corrected, in its attitude control system four months after launch. The public broadcasting company, which carried no insurance on the first BS-2, finally took control of the spare BS-2 in July 1986 and started two-channel DBS service at yearend.

The BS-2 satellites, like the experimental BSE, were designed and built by General Electric Co. for prime contractor Toshiba Corp. The company and its Japanese subcontractors did only about 30 percent of the work on the two units, mainly the communications antennas and some components for other communications subsystems, with GE supplying the transponders and other critical equipment. Yet, as prime contractor, Toshiba paid the price for the BS-2's problems, losing the bidding for the follow-up DBS contract. (GE, although it would have shared the BS-3 contract award had Toshiba won it, later came out ahead in one respect. In late 1988 NHK ordered a previously built but never launched broadcast satellite from the American manufacturer to back up the BS-2b, which has experienced additional problems.)

Since NHK and a new private broadcast company are funding 65 percent of the BS-3, the public broadcasting corporation had a big say in NASDA's September 1985 decision to give the project contract to NEC. Still, the space agency's unprecedented switch of prime contractors also reflected reordered priorities for the broadcast satellite program. Boosting domestic content came before design improvements, which were limited to increasing the transmission output of the transponders, incorporating three primary and three spare transponders on each of the identical BS-3s for three-channel TV service and extending the satellite's service life from five to seven years. Given this emphasis and the need to ensure the reliability of the new spacecraft, expected to cost Y78.4 billion ($560 million) to develop and launch, NASDA felt more comfortable going with NEC. For one thing, that company had done more work on transponders than Toshiba.

NEC teamed up with RCA Corp. (now, ironically, a GE unit) on the BS-3 project instead of long-time partner Hughes Aircraft because NASDA insists that broadcast satellite contractors use a three-axis-stabilized attitude control system rather than the less complex spin stabilization system used by Hughes. RCA helped NEC with the BS-3's basic design and is supplying the spacecraft's service module, which provides essential support functions. NEC, however, is in charge of the communications module and is doing the AIT work on both satellites, scheduled for launch in the summer of 1990 and a year later. Its responsibilities largely account for the estimated 80 percent-plus Japanese content of the BS-3 spacecraft, but the first made-in-Japan apogee kick motor (used to move a satellite from an elliptical orbit after launch to a drift orbit and finally to its stationary orbit) also will help.

Weather Satellites - Japan's weather satellites illustrate the flexibility inherent in NASDA's parallel development strategy. The NEC-Hughes Aircraft team has turned out four generations of geostationary meteorological satellites and started work this year on the fifth, currently scheduled for launch in early 1994. The domestic content of GMS-5, however, will be no higher than the 32 percent figure for the recently launched GMS-4, which, in turn, was similar to NEC's contribution to GMS-3 and GMS-2; Hughes once again will have design and AIT authority, and prime contractor NEC will remain responsible for parts of the communications and the sensing payloads. This static division of labor has nothing to do with NEC's capabilities in the satellite field. Instead, it reflects NASDA's repeated decision to put service before experience.

The same low-risk logic also has dictated the space agency's incremental approach to GMS technical advancement. For example, the main difference between the next weather satellite and the current one is that GMS-5 will carry more sensors. That could change in the future, however, if the Ministry of Transportation, which operates the country's weather satellites through its affiliated Japan Meteorological Agency, goes ahead with its current plan to make the GMS spacecraft multipurpose satellites with locational measurement and communications services functions. As the first step in this direction, GMS-5 will have signal relay equipment for search and rescue operations.

Earth Observation Satellites - NASDA's remote-sensing satellite program is the end product of its parallel development strategy, a chance for Japanese manufacturers to develop advanced spacecraft using their own technology. MOS-1, a Y56 billion ($400 million) earth observation satellite launched in February 1987, and its twin, set to go up in February 1990, were designed, assembled, integrated and tested by prime contractor NEC. Moreover, its Japanese subcontractors, with some software technical support from foreign firms, developed and made the major subsystems, including the three-axis attitude control unit and the data collection platform transponder. They also were responsible for MOS's trio of high technology radiometers for marine, land and atmospheric observation.

With the MOS-1 project under their belts, Japan's three satellite manufacturers now are trying to establish a new state of the art for earth observation satellites. ERS-1, under development since 1986, will be equipped with synthetic aperture radar and optical sensors to make extremely detailed geological and topographical surveys of the earth's surface. The SAR system, being developed by prime contractor Mitsubishi Electric, represents the cutting edge of satellite remote-sensing technology, capable of providing high-resolution, high-contrast observation 24 hours a day in all kinds of weather. The optical sensors are an equally ambitious undertaking. Their cost alone is expected to account for Y20 billion ($142.9 million) of the ERS-1's projected Y70 billion ($500 million) price tag. In addition, optical sensor development problems already have forced a one-year delay in ERS-1's launch to 1992.

Tough Choices for Tokyo

Ironically, world commercial satellite demand is strongest year-in, year-out in the market segment where Japanese industry now has perhaps the biggest technical and cost handicaps -- communications satellites -- and weakest in the area of potentially its greatest competitiveness -- earth observation satellites. Not surprisingly, American manufacturers have the largest lead in communications satellites and possibly the smallest in earth observation satellites. This mismatch aside and notwithstanding Commerce and USTR statements that Tokyo must abandon its satellite development program across the board to avoid retaliation, resolution of the Super 301 complaint will come down to changes in Japan's communications satellite policies and practices.

Japan's options in this area are limited. The obvious concession -- NTT's purchase of an American satellite -- is unlikely to satisfy key U.S. trade policymakers since this move would not address American worries about Japanese industrial targeting. But even if this alternative were acceptable to the Bush administration, NTT would have trouble justifying it financially.

The communications giant apparently looked into the possibility of buying a U.S. satellite after it was privatized and decided that over the medium run the Japanese market could not profitably support a NTT-operated commercial satellite communications business in addition to the competing services offered by Japan Satellite Communications and Space Communications. The country's geographical compactness and the availability of alternative ground-based systems for transmitting voice, video and data (NTT's integrated services digital network, for example) capped Japanese requirements for satellite communications services far below demand in countries like the United States, in-house analysts concluded. The Ministry of Posts and Telecommunications came to a similar conclusion in early 1986 after surveying potential users about their transponder needs through the year 2000 and, as a result, shelved an application from a third private satellite operator.

Tokyo's only other choice is to abandon plans for a follow-up to the CS-3 project. That option, while certainly unpalatable, might not be as difficult for Japan to swallow as first appears. No money has yet been budgeted for the CS-4 satellites, envisioned as state of the art for the mid-1990s, although experts said basic design work had to begin at the latest during the current fiscal year if the spacecraft are to be ready by 1995. Perhaps the main reason for the delay is that government agencies, users and manufacturers cannot figure out the financing for the project, which could cost anywhere from Y100 billion ($714.3 million) to Y150 billion ($1.1 billion).

NTT seems to have little interest in the CS-4 and certainly is not willing to foot most of the bill. It spent close to Y77 billion ($550 million) on the development of the CS-2 and CS-3 satellites. Moreover, it apparently has lined up enough capacity on the JCSATs and the Superbirds to cover its satellite transmission requirements through the end of the 1990s. NASDA, which has asked for Y2.6 billion ($18.3 million) in the FY 1990 budget to start basic design work, cannot underwrite the entire project without scrapping another major program. Even covering 30 percent of the costs, as on the CS-3, would strain the space agency's ability to fully fund projects now under way. Moreover, neither the Ministry of Posts and Telecommunications, perhaps the CS-4's biggest government supporter, nor the Ministry of International Trade and Industry, which appears ambivalent about the project, is likely to drain money from nonspace to finance the next-generation communications satellite.

Communications satellite prime contractor Mitsubishi Electric presumably is unwilling to finance a major share of the CS-4, even if the alternative is the loss of this business; the risks simply are too great. Passing on the program would not shut MELCO out of the satellite market since the company, along with Aerospatiale S.A. of France and West Germany's Messerschmitt-Bolkow-Blohm, is part of a Ford Aerospace-led satellite consortium. In any case, the United States is unlikely to demand that Japan also give up its current ETS-VI engineering test satellite project, a six-year, Y40 billion ($285.7 million) effort to develop, test and verify hardware for next-generation communications/broadcast satellites in the 2,000-kg class. This program, led by Toshiba but actively involving MELCO as well as NEC, should enable all three Japanese satellite makers to hone their design and manufacturing skills.

For further information, contact Susan MacKnight.

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The views expressed in this report are those of the author and do not necessarily represent those of the Japan Economic Institute.

Appendix 1: Japan's Applications Satellites

Name	Mission Objectives	Weight	Orbit	Launch Date	Launch Vehicle	Remarks
Communications Satellites						
Medium-Capacity Communications Satellite for Experimental Purposes (CS/Sakura)	Experiments with satellite communications systems using quasi-millimeter waves and developing techniques for operating satellite communications systems.	350 kg	Geostationary	December 1977	Thor-Delta (NASA)	Prime contractor MELCO but designed and built by FAC.
Experimental Communications Satellite (ECS/Ayame)	Development of launching, tracking/control and attitude control technologies for communications satellites as well as millimeter-wave experiments.	130 kg	Geostationary	February 1979	N-I-5	Prime contractor MELCO but designed and built by FAC. Failed to achieve planned orbit.
Experimental Communications Satellite-2 (ECS-b/Ayame-2)	Same as ECS/Ayame.	130 kg	Geostationary	February 1980	N-I-6	Prime contractor MELCO but designed and built by FAC. Failed to achieve planned orbit.
Communications Satellite-2a (CS-2a/Sakura-2a)	Provide public communications services to remote islands and maintain communications during national disasters and other emergencies as well as develop satellite communications technology.	350 kg	Geostationary	February 1983	N-II-3	Prime contractor MELCO but designed and built by FAC. Designed service life reached.
Communications Satellite-2b (CS-2b/Sakura-2b)	Same as Cs-2a/Sakura-2.	350 kg	Geostationary	August 1983	N-II-4	Designed by FAC but prime contractor MELCO did assembly, integration work and environmental testing. In-orbit spare. Designed service life reached.
Communications Satellite-3a (CS-3a)	Expand communications services provided by CS-2, including limited use by business, and advance technology for communications satellites.	550 kg	Geostationary	February 1988	H-I-3	Designed and built by prime contractor MELCO. Designed service life seven years.
Communications Satellite-3b (CS-3b)	Same as CS-3a.	550 kg	Geostationary	September 1988	H-I-4	Designed and built by prime contractor MELCO. Designed service life seven years. In-orbit spare.
Broadcast Satellites						
Medium-Scale Broadcasting Satellite for Experimental Purposes (BSE/Yuri)	Image and audio transmission tests by satellite and development of techniques for operating satellite broadcasting systems.	350 kg	Geostationary	April 1978	Thor-Delta (NASA)	Prime contractor Toshiba but designed and built by GE.

Name	Mission Objectives	Weight	Orbit	Launch Date	Launch Vehicle	Remarks
Broadcasting Satellite-2a (BS-2a/Yuri-2a)	Eliminate poor television reception in mountainous areas, outlying islands and urban environments with tall buildings and develop satellite broadcast technology, including direct broadcast satellite service.	350 kg	Geostationary	January 1984	N-II-5	Prime contractor Toshiba but designed and built by GE. Designed service life five years but both of primary transponders failed within few months of launch.
Broadcasting Satellite-2b (BS-2b/Yuri-2b)	Same as BS-2a.	350 kg	Geostationary	February 1986	N-II-7	Prime contractor Toshiba but designed and built by GE. Originally meant as in-orbit spare. Used for DBS service although experiencing problems.
*Broadcasting Satellite-3a (BS-3a)	Expand broadcasting services provided by BS-2 and home satellite broadcasting technology.	550 kg	Geostationary	Summer 1990	H-I-7	Prime contractor NEC but working with GE's RCA unit. Designed service life seven years.
*Broadcasting Satellite-3b (BS-3b)	Same as BS-3a, although one transponder (channel) will be used for high-definition television broadcasting.	550 kg	Geostationary	Summer 1991	H-I-8	Prime contractor NEC but working with GE's RCA unit. Designed service life seven years. In-orbit spare.
Earth Observation/ Meteorological Satellites						
Ionosphere Sounding Satellite (ISS/Ume)	Observe ionosphere to improve accuracy of forecasts and warning systems for short-wave communications.	141 kg	Circular	February 1976	N-I-2	Prime contractor MELCO. Lost contact one month after launch.
Ionosphere Sounding Satellite-2 (ISS-b/Ume-2)	Same as ISS/Ume.	141 kg	Circular	February 1978	N-I-4	Prime contractor MELCO. Mission completed February 1983.
Geostationary Meteorological Satellite (GMS/Himawari)	Participate in Global Atmosphere Research Program with objective of improving accuracy of Japanese weather forecasting through geostationary satellite observation of cloud formations.	303 kg	Geostationary	July 1977	Thor-Delta (NASA)	Prime contractor NEC but designed and built by Hughes. Designed service life three years but operated until June 1984.
Geostationary Meteorological Satellite-2 (GMS-2/Himawari-2)	Improve meteorological service in Japan and develop meteorological satellite technology.	296 kg	Geostationary	August 1981	N-II-2	Prime contractor NEC but designed and built by Hughes. Designed service life three years but decommissioned in late 1983 after problems developed.
Geostationary Meteorological Satellite-3 (GMS-3/Himawari-3)	Continued improvement of meteorological service in Japan and further development of meteorological satellite technology.	296 kg	Geostationary	August 1984	N-II-6	Prime contractor NEC but designed and built by Hughes. Designed service life five years.

Name	Mission Objectives	Weight	Orbit	Launch Date	Launch Vehicle	Remarks
Geostationary Meteorological Satellite-4 (GMS-4/Himawari-4)	Continued improvement of meteorological service in Japan and further development of meteorological satellite technology.	345 kg	Geostationary	September 1989	H-I-5	Prime contractor NEC but designed and built by Hughes. Designed service life five years. Will take over for GMS-3 in December.
*Geostationary Meteorological Satellite-5 (GMS-5)	Continued improvement of meteorological service in Japan and further development of meteorological satellite technology. Will also be used for search and rescue operations.	n.a.	Geostationary	Early 1994 (planned)	H-II-4	Prime contractor NEC but will be designed and built by Hughes. Expected service life five years. Development work started in FY 1989.
Experimental Geodetic Payload (EGP)	Improve accuracy of geodetic surveys by using satellites.	685 kg	Circular	August 1986	H-I-1 (two-stage test flight)	Prime contractor KHI. Designed service life five years.
Marine Observation Satellite-1 (MOS-1/Momo-1)	Observe marine phenomena, especially colors and surface temperature of sea and establish technologies common to earth observation satellites.	740 kg	Sun synchronous	February 1987	N-II-8 (two-stage)	Designed and built by prime contractor NEC. Designed service life two years.
*Marine Observation Satellite-1b (MOS-1b)	Same as MOS-1.	740 kg	Sun synchronous	February 1990	H-I-6 (two-stage)	Prime contractor NEC. Designed service life two years. Ready for launch.
*Earth Resources Satellite-1 (ERS-1)	Establish active observation technologies and collect information on land use, agriculture, forestry and environment in addition to coastal zone monitoring.	1,400 kg	Sun synchronous	Early 1992	H-I-9 (two-stage)	Prime contractor MELCO. Will have synthetic aperture radar so can observe earth 24 hours a day regardless of weather. Launch delayed a year because of problems in developing optical sensors. Expected service life two years.
*Advanced Earth Observation Satellite (ADEOS)	Continue and advance earth observation technologies developed in MOS and ERS programs, develop sophisticated optical sensors for earth observation, conduct experiments on earth observation data relay using data relay satellites and develop modular satellite as prototype for future space platform.	2,500 kg	Polar	FY 1994 (planned)	H-II-5	Prime contractor not yet selected. Preliminary design work started in FY 1988.
Engineering Test Satellites						
Engineering Test Satellite-I (ETS-I/Kiku)	Confirm launch technology, acquire satellite tracking and control technology, test antenna performance and examine satellite environment.	82 kg	Circular	September 1975	N-I-1	Prime contractor NEC. Mission lasted until late April 1982.

Name	Mission Objectives	Weight	Orbit	Launch Date	Launch Vehicle	Remarks
Engineering Test Satellite-II (ETS-II/Kiku-2)	Learn technologies for launching and tracking/controlling geostationary satellites and for controlling their attitude as well as carry out tests of onboard equipment.	130 kg	Geostationary	February 1977	N-I-3	Prime contractor MELCO. Mission completed in six months.
Enginering Test Satellite-III (ETS-III/Kiku-4)	Develop production and operations technologies for satellites requiring high power and test three-axis attitude control, deployable solar panels and onboard equipment.	385 kg	Circular	September 1982	N-I-7	Prime contractor Toshiba. Mission lasted one year but operations continued until early March 1985.
Engineering Test Satellite-IV (ETS-IV/Kiku-3)	Verify launch performance of N-II vehicle, acquire data on launch environment as well as technologies for producing and managing large satellites and test functions of onboard equipment.	640 kg	Highly elliptic	February 1981	N-II-1	Prime contractor MELCO. Mission completed in three months but operations continued until late December 1985.
Engineering Test Satellite-V (ETS-V/Kiku-5)	Verify launch performance of three-stage H-I vehicle, confirm performance of first geostationary three-axis-stabilized satellite bus system and first apogee kick motor developed in Japan and conduct mobile satellite communications experiments.	550 kg	Geostationary	August 1987	H-I-2 (three-stage test flight)	Prime contractor MELCO.
*Engineering Test Satellite-VI (ETS-VI)	Verify launch performance of H-II vehicle, establish bus technology for three-axis-stabilized geostationary satellite in 2,000 kg class and develop technologies for next-generation satellite communications, especially communications between satellites but also more advanced fixed and mobile satellite communications.	2,000 kg	Geostationary	Summer 1993 (planned)	H-II-2 (test flight)	Prime contractor Toshiba but MELCO and NEC each responsible for about 30 percent of the work. Expected service life 10 years. Design work under way.

*Funded as of FY 1989.

Key to company abbreviations:

KHI	Kawasaki Heavy Industries, Ltd.	FAC	Ford Aerospace Corp.
MELCO	Mitsubishi Electric Corp.	GE	General Electric Co.
NEC	NEC Corp.	Hughes	Hughes Aircraft Co.
Toshiba	Toshiba Corp.	RCA	RCA Corp. (now owned by GE)

Source: Adapted from Science and Technology Agency, Research and Development Bureau, Space in Japan 1988-89.

Appendix 2: Japan's Scientific Satellites

Name	Mission Objectives	Weight	Orbit	Launch Date	Launch Vehicle
Test Satellite (Ohsumi)	Learn satellite launch technology and perform engineering test of satellite, Japan's first spacecraft.	24 kg	Elliptic	February 1970	L-4S-5
Test Satellite (MS-T1/Tansei)	Test satellite environment and spacecraft subsystem technology.	63 kg	Circular	February 1971	M-4S-2
First Scientific Satellite (MS-F2/Shinsei)	Study ionospheric plasma, cosmic rays and solar radio emissions.	66 kg	Elliptic	September 1971	M-4S-3
Second Scientific Satellite (Rexs/Denpa)	Study ionospheric plasma.	75 kg	Elliptic	August 1972	M-4S-4
Test Satellite (MS-T2/Tansei-II)	Measure launch vehicle performance and study attitude control technology.	56 kg	Elliptic	February 1974	M-3C-1
Third Scientific Satellite (Starts/Taiyo)	Observe relationship between solar radiation and the atmosphere.	86 kg	Elliptic	February 1975	M-3C-2
Test Satellite (MS-T3/Tansei-III)	Measure launch vehicle performance and study magnetic attitude stabilization and ultra-violet photometry.	129 kg	Elliptic	February 1977	M-3H-1
Fifth Scientific Satellite (Exos-A/Kyokko)	Observe auroral phenomena.	126 kg	Elliptic	February 1978	M-3H-2
Sixth Scientific Satellite (Exos-B/Jikiken)	Observe space plasma phenomena. (Japan's first high-altitude scientific spacecraft.)	90 kg	Highly elliptic	September 1978	M-3H-3
Fourth Scientific Satellite (Corsa-b/Hakucho)	Observe X-ray bursts, X-ray stars, nova and soft X-ray sources. (First Japanese X-ray astronomy satellites.)	96 kg	Near circular	February 1979	M-3C-4
Test Satellite (MS-T4/Tansei-IV)	Measure launch vehicle performance and perform space technology tests important to precise satellite pointing. (First ISAS satellite to deploy solar panels.)	185 kg	Near circular	February 1980	M-3S-1
Seventh Scientific Satellite (Astro-A/Hinotori)	Observe two-dimensional hard X-ray image of solar flares and solar particle rays. (Japan's first solar research satellite.)	188 kg	Near circular	February 1981	M-3S-2
Eighth Scientific Satellite (Astro-B/Tenma)	Conduct two-dimensional imaging of celestial X-ray sources like X-ray nebulae and X-ray galaxies as well as observe X-ray bursts with high temporal and spectrum resolution.	180 kg	Elliptic	February 1982	M-3S-3
Ninth Scientific Satellite (Exos-C/Ohzora)	Investigate earth's upper atmosphere through extensive use of optics, including measurement of levels of ozone, carbon dioxide and sulfur dioxide in low ionosphere and levels of carbon dioxide in upper atmosphere.	210 kg	Elliptic	February 1984	M-3S-4

Name	Mission Objectives	Weight	Orbit	Launch Date	Launch Vehicle
Interplanetary Test Spacecraft (MS-TS/Sakigake)	Measure launch vehicle performance, gain interplanetary flight techniques, learn ultra-long-range communications technology and study attitude control technology on Halley's Comet probe. (Japan's first deep-space mission.)	138 kg	Heliocentric	January 1985	M-3SII-1
Tenth Scientific Satellite (Planet-A/Suisei)	Research interplanetary space plasma and obtain ultraviolet images of the coma of Halley's Comet. (Flew within 90,000 miles of the comet nucleus.)	125 kg	Heliocentric	August 1985	M-3SII-2
Eleventh Scientific Satellite (Astro-C/Ginga)	Provide quick response to X-ray events and provide high-quality spectral data on X-ray sources. (First ISAS three-axis-stabilized satellite.)	420 kg	Circular	February 1987	M-3SII-3
Twelfth Scientific Satellite (Exos-D/Akebono)	Observe auroras caused by particle acceleration in magnetosphere. (Carried eight observation and measurement devices.)	295 kg	Highly elliptic	February 1989	M-3SII-4
*Thirteenth Scientific Satellite (Muses-A)	Perform two or three lunar swing-by maneuvers, inject a small satellite into lunar orbit and continue lunar swing-by flights for a year in effort to master technology needed to send probes to Venus and Mars.	198 kg	Elliptic	February 1990	M-3SII
*Fourteenth Scientific Satellite (Solar-A)	Obtain high-quality images of solar flares during next solar maximum period. (Will carry two X-ray imaging telescopes, one operating in soft X-ray wave-lengths and the other in the hard X-ray spectrum.)	450 kg	Semi-circular	Summer 1991	M-3SII
*Fifteenth Scientific Satellite (Astro-D)	Provide high-resolution data on faint X-ray sources through use of X-ray telescope with long focal length.	n.a.	Semi-circular	February 1993	M-3SII
*Sixteenth Scientific Satellite (Muses-B)	Continue work needed to send probes to Venus and Mars.	n.a.	n.a.	February 1994	M-3SII
*Magnetic Field Observation Satellite (Geotail)	Observe structure and dynamics of magnetosphere tail that exists on nighttime side of earth.	574 kg	n.a.	FY 1992	U.S. space shuttle

*Funded as of FY 1989.

Source: Adapted from Science and Technology Agency, Research and Development Bureau, Space in Japan 1988-89.

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IN THIS ISSUE:

Japan's Current Account Surplus Shrinks 1
All Quiet On The Yen Front 4
Washington Watchful On Japanese Construction ... 5
IC Patent Granted To Texas Instruments 6
Top Soviet Official Seeks Thaw In Japanese-Soviet Relations 8
Japan And Israel Discuss Ties 10
Notes: Aid to Eastern Europe; Small Business Telephone Systems 12

Japan's Current Account Surplus Shrinks

Perhaps it's time to change the conventional wisdom about Japan's dollar-denominated current account surplus -- again. The imbalance shrank 23.2 percent in the July-September period, the third straight quarterly double-digit decline from year-earlier levels (Table 1). Such results confound recent thinking that itself reversed the optimism prevalent after the Plaza Accord of September 1985. At that time many experts in Japan and elsewhere expected Japan's current account surplus, which had reached $35 billion in 1984, to plummet as soon as the "Plaza-engineered" yen appreciation took hold. Within months that thinking appeared overly optimistic despite the fact that the yen continued to rise throughout 1986 and 1987. The 1987 surplus actually was more than double the 1984 level as measured in dollars. Even when the imbalance dropped to $79.6 billion in 1988, many analysts on both sides of the Pacific began to fear

Table 1: Japan's Balance of Payments

(in millions of dollars)

	Trade Balance	Exports (f.o.b.)	Imports (f.o.b.)	Services (net)	Current Account Balance	Long-Term Capital (net)
1984	$44,257	$168,290	$124,033	$-7,747	$35,003	$-49,651
1985	55,986	174,015	118,029	-5,165	49,169	-64,542
1986	92,827	205,591	112,764	-4,932	85,845	-131,461
1987	96,386	224,605	128,219	-5,702	87,015	-136,532
1988	95,012	259,765	164,753	-11,263	79,631	-130,930
1987: I	23,373	50,515	27,142	-1,348	20,962	-32,209
II	25,038	55,823	30,785	-1,601	22,762	-44,365
III	23,585	56,600	33,015	-1,757	21,189	-22,023
IV	24,390	61,667	37,277	-996	22,102	-37,935
1988: I	21,021	59,345	38,324	-1,337	18,421	-15,142
II	22,448	63,559	41,111	-2,882	18,567	-36,556
III	23,765	65,989	42,224	-3,623	19,052	-42,214
IV	27,778	70,872	43,094	-3,421	23,591	-37,018
1989: I	21,311	66,945	45,634	-3,595	16,064	-5,612
II	19,794	66,560	46,766	-4,892	14,283	-30,801
III(p)	19,668	68,050	48,382	-4,247	14,634	-20,903

Table 2: Japan's Net Purchases of Foreign Securities

(in millions of dollars)

	Bonds			Stocks		
	Purchases	Sales	Net	Purchases	Sales	Net
1984	$56,348	$29,575	$26,773	$1,570	$1,519	$51
1985	291,338	237,859	53,479	5,484	4,489	995
1986	1,346,989	1,253,965	93,024	20,917	13,869	7,048
1987	1,273,829	1,200,944	72,885	70,936	54,062	16,874
1988	1,364,061	1,278,249	85,812	76,560	73,567	2,993
1987: I	377,850	354,648	23,202	13,925	9,386	4,539
II	341,880	316,585	25,295	15,277	9,797	5,480
III	325,517	308,421	17,096	21,882	18,370	3,512
IV	228,582	221,290	7,292	19,852	16,509	3,343
1988: I	332,047	318,877	13,170	18,901	19,467	-566
II	401,293	374,371	26,922	20,518	20,643	-125
III	333,473	307,635	25,838	25,166	23,425	1,741
IV	297,248	277,366	19,882	11,975	10,032	1,943
1989: I	341,774	327,771	14,003	17,724	17,828	-104
II	487,087	461,996	25,091	21,228	15,120	6,108
III(p)	463,493	437,622	25,871	23,602	18,808	4,794

Source: Bank of Japan

that the surplus would never decline as significantly as they had expected in their Plaza Accord euphoria.

Earlier this year the hopes that were so high in the fall of 1985 had disappeared almost entirely. Japan's current account surplus actually appeared to be growing. Worse, the yen began depreciating, dimming the prospects for further progress. Yet, as soon as pessimism became the conventional wisdom, the direction of the current account took the optimistic turn indicated most recently.

Part of the explanation, of course, is the infamous J-curve, named for the swing that trade imbalances may take following a currency revaluation. Borrowing a leaf from the 1986 and 1987 arguments of the optimists, pessimists have suggested that the decline of the yen in 1989 has made Japan's exports look weaker than they actually are, thereby giving an exaggerated view of the decline in the surplus. According to this argument, the surplus will start to rise again shortly even without further yen depreciation. Partly as a reflection of this thinking, many analysts expect the full-year surplus to drop significantly in 1989 but to grow again in 1990. Nomura Research Ltd., for example, sees Japan's current account falling to $65.7 billion in 1989 but rising to $71.1 billion in 1990.

Yet even this twist is not the end of the story. Many Japanese experts looking further into the future see the surplus heading lower for somewhat different reasons. In this view, as Japanese direct investment abroad in manufacturing continues to rise, the effects on the trade balance and the current account surplus will become much more pronounced. The investment surge in 1988 and 1989 has created a demand for products from Japan to build factories while displacing few Japanese exports since the foreign plants use a high percentage of Japanese components. Over the longer term the percentage of domestic content in offshore production will rise, Japanese exports will be displaced and some goods will even be imported to Japan from the plants. In short, the effect on the surplus will be increasingly favorable over time even if direct investment flows remain at present levels. Reportedly some researchers have calculated that foreign direct investment in manufacturing will cut Japan's trade surplus, which totaled $95 billion last year, by as much as $58.3 billion in FY 1993. Presumably the effect on the current account surplus, which includes profits on overseas investment, will be somewhat smaller.

Given the less than stellar history of forecasting current account balances even a few quarters ahead, such long-range estimates have to be treated with considerable caution. But the argument does serve to show the increasingly complex trade flows involving Japan. With different rates of economic growth in Japan and abroad, J-curve effects, delayed pricing responses to exchange rate changes and the effects of investment all playing important roles, few should be surprised that the conventional wisdom concerning the direction of Japan's current account surplus has shifted more than once since 1985.

Not only trade flows but capital flows, too, are difficult to forecast accurately. Collectively, as the means of financing trade, public and private short- and long-term capital flows equal the current account balance except for a relatively small statistical discrepancy. Japanese net purchases of foreign stocks and bonds between July and September remained at approximately the levels of a year earlier (Table 2). The reduction in the net capital outflow from Japan that accompanied the year-to-year decline in the current account surplus was accounted for by much larger net flows of short-term funds into Japan and larger net foreign purchases of Japanese stocks and bonds. Of the $21.3 billion year-to-year reduction in the net long-term capital outflow shown in Table 1, $13.1 billion resulted from larger foreign purchases of Japanese bonds. If this result were to become a trend, reductions in the current account surplus would not necessarily lead to a commensurately smaller Japanese presence in U.S. and other overseas capital markets but rather a larger foreign presence in Japanese markets.

Douglas Ostrom

All Quiet On The Yen Front

Events in Eastern Europe may be threatening to turn international economic relations upside down this fall, but one unexpected island of stability has emerged: the yen-dollar exchange rate. Since late summer it has been stuck in the lower Y140=$1.00 range. The U.S. and Japanese currencies have been relatively stable against each other in contrast to their status vis-a-vis the currencies of Western Europe. West Germany, closest to the upheaval on many fronts, has seen its Deutsche mark surge against both the yen and the dollar. At the end of August a Deutsche mark fetched about Y74, but by November 24 it was worth almost Y80. The British pound and the Swiss franc showed smaller gains against the yen.

Analysts, including Satoshi Sumita, the governor of the Bank of Japan, attributed the Deutsche mark's strength to the belief among currency traders that the West German economy is likely to receive an economic boost from East German trade, leading to higher interest rates that would tend to create a capital inflow and a demand for Deutsche marks. Mr. Sumita also commented on the yen's own prospects, suggesting that BOJ continues to worry about inflation and is waiting for the effects of the October 11 boost in the discount rate to work its influence on the Japanese economy. Higher interest rates are supposed to induce Japanese funds to stay at home, thereby suppressing the demand for the dollar and other foreign currencies and leading the yen higher or at least stemming a decline. In BOJ's view inflationary pressures would ease because aggregate demand would be reduced and because imports would be lower priced than otherwise.

Data through October hint that BOJ has taken comparable actions in the currency market by leaning against dollar appreciation. After peaking at over $100 billion at the end of May, foreign exchange reserves have declined every month, reaching $84 billion at the end of October. The reduction in the reserves, widely interpreted as indicative of a move to create an artificial demand for yen in currency markets, comes in stark contrast to the tripling of Japan's reserves between early 1986 and earlier this year when BOJ was often involved in efforts to keep the yen's rise from running amok.

The quiet on the yen-dollar front may not last once the events of the fall are fully digested. In the United States, despite official efforts to discourage such speculation, the Federal Reserve Board is widely expected to loosen money, building on monetary relaxation earlier this year. In Japan some large Japanese bond issuers, such as electric power companies and Nippon Telegraph and Telephone Corp., reportedly are shifting their bond fund-raising to foreign markets. NTT and the utilities have found few domestic buyers for and is deliberating how best to use these islands for the benefit of both the Soviet Union and Japan. Only time will tell whether Moscow is sincere in its desire to break this deadlock in a manner beneficial to both countries or simply trying to hoodwink Tokyo so it can tap Japan's enormous wealth.

Barbara Wanner

Japan And Israel Discuss Ties

Israeli Foreign Minister Moshe Arens met with Japan's top leaders in early November to discuss Middle East peace prospects and ways to improve bilateral links. Mr. Arens and Foreign Minister Taro Nakayama agreed to establish a consultation mechanism that would help strengthen bilateral relations -- rocky since Japan sided with Arab nations after Israel's Six-Day War in 1967 -- and facilitate discussions on the Middle East peace issue. The first such meeting is scheduled for early 1990. More specific details about the types of issues to be discussed within this framework have not yet been announced.

In the Middle East Japan traditionally has had closer ties with Arab countries than with Israel. Tokyo has considered it a priority to ensure a supply of oil from the region, especially since the oil shocks of the 1970s. Many Japanese corporations have not dealt with Israeli companies due to possible Arab backlashes, such as being cut off from contracts. While Japan's trade with Israel is less than that with most Middle East nations (see JEI Report No. 22B, June 10, 1988), it has increased dramatically over the past five years. Exports to Israel more than doubled between 1984 and 1988 and imports more than tripled over the same period (see Table 1). Japan, however, gives very little aid to Israel and what it does give is all in the form of technical cooperation. In 1988 that amounted to $380,000 (see Table 2).

Table 1: Japan's Trade with Israel, 1984-88

(in millions of dollars)

Year	Exports	Imports	Trade Balance
1984	$173.5	$190.8	$17.3
1985	170.4	214.9	44.4
1986	274.9	322.4	47.5
1987	346.0	481.2	135.1
1988	420.4	684.5	264.0

Source: Japan Tariff Association

Since Japan enjoys good relations with the Arab nations, Israel hopes that Tokyo can persuade those nations to develop a more friendly attitude toward Jerusalem. There are, however, points of contention between Israel and Japan, including Japan's support of a Palestinian homeland and backing for negotiations that include representatives of the Palestine Liberation Organization. Prime Minister Toshiki Kaifu reinforced those points in his meeting with Mr. Arens. Stressing the importance of achieving regional peace, Mr. Kaifu suggested the necessity of trading land for peace. The prime minister also told

Table 2: Japan's Foreign Aid To Israel, 1984-88

(in thousands of dollars)

Year	Grants		Loans	Total
	Grant Aid	Technical Cooperation		
1984	--	$170	--	$170
1985	--	180	--	180
1986	--	340	--	340
1987	--	360	--	360
1988	--	380	--	380

Source: Ministry of Foreign Affairs

Mr. Arens that it probably is unrealistic for Israel to refuse to negotiate a peace settlement with PLO representatives. PLO leader Yasir Arafat was an informal guest of the Japanese government earlier this fall when he also met with Mr. Kaifu and Mr. Nakayama.

Israel's position is that the Palestinians already have a homeland in Jordan, where they comprise a large portion of the population, so it is unnecessary to negotiate a second homeland. "A Palestinian state would be a danger to our very existence," an Israeli diplomat told the press in Japan.

In what seemed to be a significant breakthrough, however, Israel in early November conditionally accepted a proposal by Secretary of State James Baker for peace talks between Israeli and Palestinian representatives with U.S. and Egyptian coordination. Israel has specified that the PLO be excluded from the talks and that only the possibility of elections in the territories occupied since the 1967 war be discussed. If Egypt accepts the conditions, representatives of the three countries would meet in Washington as a precursor to direct Israeli-Palestinian talks likely to take place in Cairo. Israel would like to limit voting for a Palestinian representative only to residents of the West Bank and the Gaza strip, excluding Palestinians living outside these territories. Another complication affecting the proposed dialogue has been an indication by the PLO that it does not want to participate in such talks. The United States continues to press Egypt, however, to persuade the PLO to acquiesce to preliminary talks between Israel and other Palestinian representatives.

The visit to Tokyo by Mr. Arens is seen as an indication that ties between the two countries are slowly increasing. Official visits have been scarce. Then Vice Prime Minister Yitzhak Shamir visited Tokyo in 1985 and former Foreign Minister Sosuke Uno made a stop in Israel in June 1988 during a tour of the Middle East. Although there may be a thaw in relations, experts do not expect quick progress.

Through increased dialogues with the regional players, Japan may be assuming a role in world politics more in line with its economic power. But, since Israel is still considered of key interest to the United States, analysts expect Washington to take the lead in mediating a peace settlement in the Middle East. Japan, however, may be able to use its influence to help nudge the process forward.

Gretchen Green

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JAPAN'S TELECOMMUNICATIONS MARKET: 1989 UPDATE

Summary

Almost five years after Tokyo implemented major regulatory reforms, Japan's telecommunications market has been changed significantly by the proliferation of private common carriers and secondary service providers. Despite the entry of new firms, the domestic and international common carrier markets still are dominated by the former government-owned monopolies -- Nippon Telegraph and Telephone Corp. and Kokusai Denshin Denwa Co., Ltd., respectively. Nevertheless, price competition is intense between the ex-monopolies and the new common carriers. Friction with trading partners, particularly the United States, over telecommunications also has not completely vanished in the wake of the 1985 reforms. These situations have generated sharp domestic debate about further restructuring of the telecommunications market and revisions of telecommunications policy.

1985: A Brave New World

Until April 1, 1985 Japan's telecommunications market was structured as a monopoly because the government thought that a strong central authority was the most efficient way to address the central issues of telecommunications policy. Prior to World War II the rapid construction of a telecommunications infrastructure was the focus; rebuilding and modernization were the main objectives after the war. In 1952 Nippon Telegraph and Telephone Public Corp. was given a monopoly over the domestic communications market, while Kokusai Denshin Denwa Co., Ltd. had total control over Japan's international communications links. By 1980 NTT had achieved its goals of eliminating its backlog of telephone installation orders and implementing nationwide direct-dial service. KDD also had achieved by this time its main goal of building a full range of global communications links.

At the start of this decade, therefore, both NTT and KDD had lost a major raison d'etre. Tokyo, however, felt that a monopoly structure for the international telecommunications market still was useful because a single national authority simplified negotiations with international telecommunications organizations, such as the International Telecommunications Union. This logic did not apply to NTT, which users and policymakers alike viewed as increasingly unresponsive to customers and slow to implement new technology. Domestic makers of telecommunications gear and foreign providers of enhanced telecommunications services also sought to broaden their market by advocating telecommunications deregulation.

Across the Pacific the move toward deregulation of the American telecommunications market undoubtedly served as a model for Japanese policymakers. They watched with great interest the 1984 breakup of American Telephone and Telegraph Co. into a long-distance carrier and several regional carriers. Privatization of government monopolies was also a part of then Prime Minister Yasuhiro Nakasone's drive to reduce the size and improve the efficiency of government. Final recommendations by the ad hoc Commission on Administrative Reform proposed in 1983 that NTT, Japan Tobacco and Salt Public Corp. and the Japanese National Railways be reorganized into private ventures. A year of debate produced a plan divided into two main parts -- the privatization of the domestic government telecommunications monopoly and the entry of private firms into the telecommunications services market.

NTT Privatization - Dropping the word "Public" from its official name, NTT shifted on April 1, 1985 from its public enterprise status to being a joint stock corporation. The new NTT was capitalized at Y780 billion ($5.6 billion at Y140=$1.00), far above the Y18.8 billion ($134.3 million) capitalization at its inception in 1952. Initially, the government held all 15.6 million NTT shares. Tokyo pledged to put at least one-half and as much as two-thirds of NTT stock into private hands by 1992. (Foreigners are not allowed to own shares, however.) After three releases of NTT stock between 1986 and 1988, 5.3 million shares are in the hands of an estimated 1.5 million private investors.

Although the government still must approve the new NTT's budget and business plan, the procedure is simpler than the old requirement to secure Diet approval. Still obliged to provide nationwide telephone service and conduct research and development in telecommunications, NTT now has gained the ability to change its service rates (with authorization from the Ministry of Posts and Telecommunications) and the freedom to invest in areas other than telecommunications. Finally, the board of directors is elected by the shareholders rather than appointed by MPT, although the ministry's authorization still is necessary for any board changes.

NTT, although privatized, continues to adhere to the terms of a procurement pact negotiated by the United States and Japan in 1981. Extended through 1989 (see JEI Report No. 42B, November 14, 1986) and expected to be renewed

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again, the agreement facilitates equipment bids from foreign suppliers and makes NTT's long-term equipment and technology development programs open to them. In fact, NTT's president has stated repeatedly that the firm will buy the best products regardless of their national origin.

Market Deregulation - The legislation mandating reform specifies two types of telecommunications businesses. Firms that build or own their own telecommunications circuit facilities are classified Type I. These firms must obtain MPT's permission to begin and cease operations as well as to change their tariff schedules. They also must heed any government orders to amend tariff rates, to "improve business activities" and to "interconnect or share telecommunications facilities." Foreign control of Type I firms is not permitted.

All other telecommunications firms are classified Type II. This does not mean Type II firms cannot be common carriers. Companies can rent or lease circuits from a Type I firm and provide voice/data services to the general public on a nationwide scale. These services for "many and unspecified persons with large-scale networks" are considered Special Type II firms. All others are General Type IIs. Special Type IIs must register with MPT to begin operations, but need only notify the ministry if they intend to go out of business or change rates. General Type IIs are expected to notify MPT of their plans in all instances. All Type II firms are subject to government oversight.

Reagan administration trade negotiators, anxious to ensure that American suppliers of telecommunications equipment and services had the same access to Japan's soon-to-be-open market as their Japanese competitors, were active participants in the 1984 deregulation debate. Keeping up the pressure as Tokyo moved from the planning stage to the implementation phase of the deregulation process, Washington used the 1985 MOSS (market-oriented, sector-selective) talks to push for the greatest possible degree of national treatment for foreign firms and minimum government control over the deregulated market.

One of the most difficult areas for Japan and the United States to negotiate was telecommunications terminal equipment standards and approval. MPT, in its traditional role as guarantor of telecommunications quality and satisfaction to the Japanese consumer, sought to establish strict standards across a broad range. U.S. negotiators wanted just the opposite: limiting MPT's role to insuring only that terminal equipment does not harm the network. They contended that all other performance and appearance standards were unnecessary. MPT eventually agreed to the majority of Washington's requests. Technical standards were reduced from 53 to 21. The private Telecommunications Technology Committee, to which foreign firms also belong, was established in October 1985 to draft all subsequent standards. The Japan Approvals Institute for Telecommunications Equipment was founded as an independent testing and certification body to approve equipment from all companies (including NTT); it agreed to accept foreign test data for approval purposes.

A related issue of concern, which the United States brought up during the MOSS negotiations, was transparency in the standards-drafting process and in the approval procedure. To make MPT's administrative and policy processes more open Japanese employees of foreign-affiliated companies were invited to participate in MPT's advisory councils, including the ministry's Telecommunications Council and the private TTC. In addition, MPT pledged to continue working toward greater transparency. The ministry also plans to improve the distribution of information to foreign firms as well as continue to seek their opinions.

Cellular (mobile) telephone service, which relies on wireless transmission, was outside the realm of the deregulation legislation, but the United States initiated discussions within the MOSS framework on amendments to the Radio Law in an effort to liberalize this lucrative NTT monopoly. Complicating factors were Tokyo's previous allocation of portions of the radio spectrum in a way distinct from that used in the United States and NTT's use of a cellular telephone format that was different from the U.S. standard. The latter situation meant that foreign firms would have to alter their equipment for sale in Japan, which they were reluctant to do. MPT thus asked the TTC to examine whether Japanese and foreign standards could coexist. The council reported in April 1986 that this was technically feasible.

MPT then agreed to amend the Radio Law effective July 1, 1986 to allow foreign firms to obtain a license to operate a private radio facility for mobile communications on land. Based on modest market growth projections, however, MPT calculated that the domestic market for cellular telephone service could support only a limited number of providers. Because the choice of equipment was left to each provider, Washington was very interested in ensuring that applicants proposing to use foreign equipment were given an equal opportunity. After extensive negotiations, the ministry proposed to divide the country into two service zones; only NTT and one other private firm would be allowed to compete in each zone. While this idea was welcomed at the time in Washington, it proved to be only a temporary solution. (Recent developments in the cellular telephone market will be discussed below.)

Equipment standards outlined by the Radio Facilities Technical Compliance Certification System were simplified and limited to those necessary to "avoid interference with other users" and to encourage "the efficient use of frequencies." The previous minimum of 10 standards was reduced to one with the nine others becoming voluntary. Approval procedures followed by the Radio Equipment Technical Certification Institute also were simplified, and foreign test data became acceptable.

Outside the MOSS framework Tokyo took two steps specifically aimed at encouraging imports of foreign products. As part of a July 30, 1985 market liberalization package, tariffs on five items -- telephone instruments (4.2 percent), telegraph equipment (3.6 percent), electronic switches (5.7 percent), current-carrier equipment (3.6 percent) and radio communications equipment (4 to 5.1 percent) -- were eliminated at the end of 1986. In addition, special depreciation rates and tax exemptions were introduced for imported mechanical or electronic products to encourage small businesses to broaden their purchasing practices. In contrast to the normal first-year depreciation allowance of 30 percent, small firms can depreciate 36 percent of the cost of qualified imported items. Moreover, buyers of imported high technology equipment qualify for an 8.4 percent tax exemption as opposed to 7 percent for domestic products.

A Market Unbound

Japan's telecommunications market has surprised both users and policymakers with its enthusiastic response to the new regulatory environment. In some respects, such as the degree of competition in particular segments, the Japanese market has surpassed its U.S. counterpart; in other areas Japan has lagged. The proliferation of services and providers has led to cutthroat price competition and a boom in most, but not all, forms of telecommunications consumption (see Table 1).

Table 1: Summary Statistics of Japan's Telecommunications Market

	FY 1984	FY 1985	FY 1986	FY 1987	FY 1988
Service Subscriptions (thousands)					
Home Telephones	30,206	31,152	32,075	33,139	34,362
Office Telephones	13,336	13,709	14,250	14,837	15,542
Subtotal	43,542	44,861	46,325	47,976	49,904
Car Telephones	40.4	62.1	95.1	120.8	323.1
Radio Pagers	1,886.0	2,155.9	2,487.9	2,836.7	n.a.
Telegraph	33.9	36.0	33.9	33.3	n.a.
Facsimile	18.2	46.3	85.2	148.1	297.8
Leased Circuits	498.6	534.3	574.9	661.2	747.0
High-Speed Data	n.a.	n.a.	4.2	5.5	n.a.
Circuit Switching	2.7	4.0	5.2	5.9	n.a.
Packet Switching	6.6	14.2	27.8	40.7	n.a.
Domestic Communications Volume (millions)					
Telephone	57,000	63,200	71,800	80,000	n.a.
Telegram	41.7	40.7	40.1	41.0	41.5
Electronic Mail	0.6	2.9	5.0	4.9	n.a.
International Communications Volume (millions)					
Telephone, Sent	34.7	48.6	68.9	96.1	129.1
Telephone, Received	33.8	45.6	65.3	92.2	123.0
Telegram	1.9	1.5	1.2	1.0	n.a.
Telex	52.1	50.1	43.8	24.2	n.a.
Leased Circuits (number)	961	1,067	1,149	1,244	n.a.

Source: Ministry of Posts and Telecommunications

Telephone - The number of telephone subscribers had reached nearly 50 million by the end of 1988, about 40 subscribers for every 100 persons. At the start of the decade the saturation rate hovered in the low 30s after a spurt in the 1960s and 1970s. Between 1970 and 1975, the height of the boom, 14.6 million subscribers signed up. As NTT caught up with demand the increase fell to 7.3 million between 1976 and 1980 and to 6.4 million in the following five years. With one more year to go in the 1986-90 period it appears that the number of new users -- given the upward trend in the annual rate of increase -- will be slightly higher since just over 5 million new lines already had been added by the end of 1988. In keeping with the growth in telephone subscriptions the number of domestic calls also is moving up. This figure, however, outstrips the rate of increase for new subscribers, meaning that people are making more calls than ever before.

- Cellular - Although mobile telephones have been available in Japan since 1979 and pocket pagers since 1969, the market's potential remained largely untapped until 1985. By the end of that year cellular telephone service had expanded to 473 cities from one in 1979 and to 61,786 users from 1,557 six years earlier -- in effect more than doubling every year. As of March 31, 1989 well over 240,000 subscribers had tapped into nationwide service. Although not as spectacular, the growth of paging receivers averaged 14.3 percent in fiscal 1985 for a total number in use of approximately 2.2 million, 15.4 percent in FY 1986 (2.5 million) and 14 percent in FY 1987 (2.8 million), according to MPT estimates. Advances in electronic miniaturization are expected to give a boost to both the cellular telephone and pocket pager markets.

- International - Given Japan's burgeoning global ties in trade and finance, the ballooning volume of international communications is no surprise. Measured by both calls made and calls received, the market has more than quintupled since 1982. While U.S. demand for transpacific services also has jumped in recent years, analysts point to the Japanese penchant for consensus-style management as the source of the skyrocketing volume in international telecommunications. Globalization of Japan's mass media, particularly newspapers, also has contributed to the upsurge in demand. All of Japan's major dailies transmit stories around the globe by satellite. Foreign editions containing exactly the same stories that appear in Japan that day often are marked "satellite edition." It is no wonder, then, that the international communications market has attracted private competitors.

Telegraph - Usage of this communications medium has suffered as a result of the boom in telephone and similar data communications services. The numbers of telegrams and telexes sent domestically and internationally have been on the wane for many years. Telegraph operators' recent efforts to distinguish their service from that of competitors have included offering telegrams that look like greeting cards, are custom-designed for special occasions or include music or a recorded voice message. Only time will tell if these value-added services can halt the decline of this format's popularity.

Leased circuits - Driven by the computerization of Japanese industry and finance, a domestic part of this market has grown from 500,000-plus leased circuits in FY 1985 to 747,000 by the end of FY 1988. In addition to the leasing income, however, providers generate additional revenues from related consulting and management services. High-speed digital leased circuits have been a particularly bright spot, with the average growth of new leases hitting 40 percent in FY 1988. Competition is fierce as many private firms have flocked to the leased-circuit market.

Data/digital services - This market has developed rapidly as manufacturers, financial institutions, tertiary industries and the government have computerized or digitized operations. Custom data communications services linking banks and credit bureaus with retailers or a distributor's network of warehouses with its delivery vehicles are increasingly common. Government agencies, such as the Japanese Patent Office, are taking advantage of the technological advances to design a "paperless" patent application and processing system.

Digital circuit and packet-switching services are benefiting from the explosion in demand for high-capacity data and facsimile transmissions. The number of digital data service subscribers more than doubled in FY 1988, topping 130,000. With new options, such as ISDN (integrated services digital network), rapidly becoming available nationwide the digital services market is expected to continue its sharp expansion.

Other services - Demand for videotex, facsimile and video conference services is growing, but unevenly. Calls for special facsimile services, such as high-volume, multi-recipient or confidential transmission, are increasing briskly, with about 100,000 new service contracts signed annually over the past two fiscal years. The videotex market, dominated by NTT's CAPTAIN (Character and Pattern Telephone Access Information Network), has enjoyed only moderate growth since its introduction in 1984. It is likely that videotex will be absorbed by ISDN since ISDN offers every feature of videotex and many others to boot. Video conferencing has been the slowest to take off, mainly because the cost remains relatively high. Yet, as construction of so-called intelligent buildings (which have integral and integrated video, computer and communications systems) increases and as advances are made in the manufacture of video and transmission equipment, demand should rise as costs fall.

The Contenders

The influx of private service providers generates much of the new vitality in Japan's telecommunications market. In some markets the impact of deregulation was immediate, but in others it has take several years for competition to come on-line.

As defined by the Telecommunications Business Law, private service providers fit into one of two categories:

Type I carriers - As mentioned above, a Type I firm can provide any kind of service but must own its transmission facilities. Currently 40 firms, including NTT and KDD, have received MPT's approval as Type I carriers and have begun operations (see Table 2).

- Domestic long-distance services - This group includes three terrestrial transmission firms and two companies using satellite linkups. The terrestrial companies -- Daini Denden Inc., Japan Telecom Co., Ltd. and Teleway Japan Corp. -- have focused their attention on the heavily populated areas incorporating Tokyo, Osaka, Kyoto and Hiroshima. Tokyo's role as the center of government and private business activity makes it critical to each firm. Within a year of initiating operations in 1986 by offering leased circuits, all three expanded into long-distance telephone service. Their prime marketing tool is prices cheaper than NTT's. For example, a 3-minute call made in 1987 between Tokyo and Osaka cost Y400 ($2.86) if placed through NTT but only Y300 ($2.14) if made through one of the new common carriers.

Although NTT has fought to close the price gap, the NCCs are confident that they can undercut the ex-monopoly and remain profitable. The latest financial figures support this boast. All three firms more than doubled their sales and posted sharply higher profits in the first half of FY 1989 than in the April-September 1988 period. Daini Denden earned a net profit of Y5.4 billion ($38.6 million) on sales of Y39.5 billion ($282.1 million). Japan Telecom had

Table 2: New Type I Telecommunications Carriers

Company	Service*	Area of Operation	Operation Date
Long Distance Services			
Daini Denden Inc.	T, LC	Tokyo, Aichi, Osaka, Hiroshima, Fukuoka, Miyagi	9/4/87 (T) 10/24/86 (LC)
Japan Telecom Co., Ltd.	T, LC	Tokaido, Sanyo, Tohoku and Joetsu bullet train lines	9/4/87 (T) 8/1/86 (LC)
Teleway Japan Corp.	T, LC	Tokyo-Nagoya and Osaka-Nagoya expressways	9/4/87 (T) 11/11/86 (LC)
Satellite Services			
Japan Communications Satellite Co., Inc.	LC	All areas	5/89
Space Communications Corp.	LC	All areas	7/8/89
Regional Services			
Tokyo Telecommunications Network Co., Ltd.	T, LC	Kanto area	5/1/88 (T) 11/1/86 (LC)
Tube Telecommunications Co., Ltd.	LC	Aichi, Gifu, Mie, Shizuoka	6/1/88
Osaka Mediaport Co., Ltd.	LC	Osaka, Kyoto, Hyogo, Shiga, Nara and Wakayama	3/1/87
Lake City Cablevision Co., Ltd.	LC	Suwa, Osaka and others	12/1/87
International Telecommunications			
International Telecom Japan Inc.	T, LC	All areas	10/1/89 (T) 4/1/89 (LC)
International Digital Communications Inc.	T, LC	All areas	10/1/89 (T) 5/1/89 (LC)
Mobile Telephone Service			
Nippon Idou Tsushin Co., Ltd.	T (car)	Tokyo, Kanagawa, Saitama, Chiba, Ibaraki, Aichi, Mie and Gifu	12/31/88
Kansai Cellular Telephone Co., Ltd.	T (car)	Osaka, Kyoto, Hyogo, Shiga, Nara and Wakayama	4/1/88
Tokyo Bay Marine Telecommunications Co., Ltd.	T (ship)	Tokyo Bay and vicinity	9/1/88
Railway Communications Co., Ltd.	T (rail) LC	Nationwide except Nara, Saga and Okinawa prefectures	4/1/87
Radio Paging Services			
23 firms		All areas	

*T = Telephone, LC = Leased Circuit

Source: Ministry of Posts and Telecommunications sales of Y34.3 billion ($245 million) and net profits of Y1.9 billion ($13.6 million). Teleway Japan's results were the least impressive with sales of Y10.9 billion ($77.8 million) and net profits of Y0.1 billion ($714,300).

The NCCs complain that MPT is restraining their efforts to expand their areas of service. Because they must pay a fee to access NTT's local telephone network for every call made through their long-distance lines they also complain that the more business they win, the more they have to pay NTT. These and other competitive issues have become part of the debate over NTT's future (discussed below).

Two companies began offering nationwide communications services via satellite this year (see JEI Report No. 45A, December 1, 1989). Japan Communications Satellite Co., Inc. and Space Communications Corp. each have one satellite in operation and a second scheduled for launch in the near future. JCSAT has 32 transponders on its Hughes Aircraft Co. satellite, while SCC's Ford Aerospace Corp.-built satellite has 29 transponders. Although MPT predicts that by 2004 eight communications satellites with 400 transponders will be serving Japan and generating Y200 trillion ($1.4 trillion) in sales, the two firms face a tough fight. In Japan satellites do not have the clear advantage over ground-based communications links that they do in the United States because of the country's relatively small geographic size and its highly concentrated population. The two firms also have a credibility problem to overcome. Neither firm can provide absolute guarantees of when their satellites will be operational since they are dependent on foreign launch services and the competition for space is stiff. SCC also experienced transmission problems with its first satellite soon after it went into operation, making customers wary.

- Regional telephone services - This is one area where consumers in Japan enjoy a greater degree of competition than in America. At least four firms compete with NTT for intracity services. There also are signs that several city governments are considering entering the market, laying communications cables in municipal water and sewer system lines.

The market for mobile telephone services also is a hot topic in Japan. Two private firms -- Nippon Idou Tsushin Co., Ltd. (known as IDO or Japan Mobile Communications Co., Ltd.) and Kansai Cellular Telephone Co., Ltd. -- compete with NTT in two distinct regions. IDO, which is backed by Toyota Motor Corp., has the more lucrative Tokyo-Nagoya zone and uses equipment based on NTT's protocol. KCT, which is backed by Daini Denden, offers equipment from Motorola Inc., Toshiba Corp. and Oki Electric Industry Co., Ltd. using both NTT and U.S. protocols.

A U.S.-Japan accord on cellular telephone service, reached in June (see JEI Report No. 26B, July 7, 1989), will stoke the intense competition to install new base stations and add service zones by allowing KCT to offer limited service in the Tokyo-Nagoya corridor. KCT's introduction of Motorola's Micro TAC (total access communications) telephone -- currently the smallest and lightest unit in the world -- has added to the booming demand for cellular phones. Observers predict that demand will skyrocket when prices start to come down. NTT, which has the highest rate structure, charges Y230,000 ($1,643) to obtain the equipment and initiate service, another Y15,000 ($107) a month as a basic service fee, and actual calling charges of Y10 ($.07) for every 6.5 seconds for calls up to 100 miles (which works out to about Y300 ($2.14) for a 3-minute intracity call compared to the normal Y10 3-minute charge).

The pocket pager market is even more crowded, with 23 private companies vying with NTT. Paging devices no bigger than a fountain pen or a credit card are typical weapons in the new competition. Declining charges for paging services are a principal marketing tool, leading some observers to predict that a shakeout will come shortly as margins become razor thin.

- International communications - This market segment currently is undergoing rapid change. After four years of preparation International Telecom Japan Inc. and International Digital Communications Inc. began battling KDD earlier this year, but they are taking different tacks. ITJ, backed by major Japanese trading companies, banks and manufacturers, is following a conservative program by focusing initially on leasing high-speed digital circuits to its backers in strong markets. ITJ presently offers circuits linking Japan with the United States, South Korea, Taiwan, Hong Kong, Singapore and Australia. The firm hopes to have linkages with a total of 21 countries, including Europe, as soon as possible. To reduce the cost of providing nationwide access to its overseas network, ITJ is exploring ties with domestic providers, such as NTT or its competitors.

IDC, which is backed by Toyota, C. Itoh & Co., Ltd., Britain's Cable & Wireless Plc, and America's Pacific Telesis International Inc., among others, leases overseas circuits and is trying to establish a market position by offering services on submarine optical fiber cables that it laid in cooperation with others. In May IDC began leasing circuits between Japan and the United States, Canada, Hong Kong and Singapore. Links to Great Britain, West Germany and South Korea were opened two months later, and IDC hopes to provide service to another 11 countries by 1990.

Both IDC and ITJ compete with KDD mainly on price -- their rates are 20 to 40 percent cheaper than KDD's. As of mid-1989 the newcomers had leased a combined 120 circuits. In an effort to gain an edge ITJ is promoting custom solutions to user needs, while IDC is touting the benefits of its fiber optic network for long-distance digital or facsimile communications. In addition to their leased circuits, both firms initiated international telephone service October 1, further expanding competition. Although no official figures are in, each firm says it is near its initial target of a 10 percent market share. With a 15 percent share targeted over the next three years, the competition is just beginning.

Type II firms - These firms can offer any kind of service but only by using communications circuits owned by a Type I company. Within this category are two subdivisions. Special Type II companies offer services "for an unspecified number of general subscribers" with a network capacity above 500 circuits capable of 1,200 bits per second or offer international communications services using other companies' equipment. General Type II companies offer services outside the definition of Special Type II. This open-ended category has allowed large and small firms to provide a wide array of enhanced telecommunications services, including value-added networks.

- Special Type II - As of November 1988 Special Type II carriers that had registered with MPT numbered 23 (see Table 3). In addition to offering data communications services, eight also offer voice services, and another nine offer image or other complex transmission services. Fourteen firms offer international VANs as well as domestic VAN services. At least 11 of the group have a

Table 3: Special Type II Telecommunications Carriers

(as of November 30, 1988)

Company	Services*	Registration Date	Foreign Share
Intec Corp.	V, I, D	4/19/85	9.6%
Fujitsu, Ltd.	D	4/19/85	7.5
Japan Information Service Ltd.	D, IVAN	4/19/85	
NEC Corp.	V, I, D, C, IVAN	4/19/85	11.6
Hitachi Information Network Ltd.	D, IVAN	4/19/85	
United Net Corp.	V, I, D, C	5/24/85	
Japan ENS Corp.	V, D, IVAN	7/17/85	50.0
Oki Network Service	V, I, D, IVAN	7/31/85	
Network Information Service Co., Ltd.	V, I, D, IVAN	11/25/85	25.24
Internetwork Inc.	D	10/15/86	
Nippon Information and Communication Corp. (NI+C)	V, I, D	7/20/87	50.0
Japan Global Van Inc.	I, D, IVAN	9/29/87	
Nomura Computer System Co., Ltd.	D, IVAN	10/9/87	
Mitsui Knowledge Industry Co., Ltd.	D, IVAN	10/19/87	
IBM Japan Ltd.	D, IVAN	10/27/87	100.0
Nihon Keizai Shimbun Inc.	I, D, IVAN	10/31/87	
Toyo Information System Co., Ltd.	D	11/27/87	
INES Corp.	D	3/30/88	10.8
NI+C International Corp.	D, IVAN	5/18/88	59.5
NTT Data Communications Systems Corp.	D, C	6/29/88	
Mitsubishi Electric Crop.	V, I, D	8/23/88	4.1
Information Services International-Dentsu, Ltd.	D, I, IVAN	9/5/88	
K-Network International Inc.	D, IVAN	11/17/88	5.0

*V=voice, I=image, D=data, C=complex, IVAN=international value-added network.

Source: Ministry of Posts and Telecommunications

foreign backer; in two cases the Type II firm is a 50-50 venture, while in two others foreign investors have a controlling interest.

- General Type II - By the end of 1988 MPT had been notified by 635 firms of their intent to offer services as General Type II carriers. About two-thirds (433) said they planned to provide data communications services. Another 192 companies indicated they would offer voice communications; less than 200 firms hoped to engage in more complex services (97 image and 81 complex transmissions.) (A number of businesses indicated they would provide multiple services.) MPT officials, however, expect that up to half of these firms have gone or will go bankrupt or that they never became fully operational because of high start-up costs and intense competition. Nevertheless, services such as electronic mail or networks linking a company's global operations have proved popular.

The Type II market initially was seen as highly lucrative and broad enough to support a large cast. In FY 1987 one private industry organization estimated the market's worth at Y350 billion ($2.5 billion). Now, however, price competition in some services, particularly where NTT or KDD are players, has reduced margins to almost nothing. NTT, for example, charges Y0.4 to Y0.6 to switch a 128-byte data packet through its network. KDD charges Y2 to Y2.4 per 64-byte packet switched through its international circuits. The only way smaller firms can compete with NTT and KDD is to offer prices significantly below these levels. Yet these small companies, if anything, are faced with higher start-up costs than either NTT or KDD and usually have much shallower pockets.

In other markets demand has lagged supply. The resale or lease of circuits for dedicated applications was expected to be a cash cow for Type II firms after market liberalization in 1985. Since then, however, competition has been so intense that this segment is unprofitable. (While the rate structures of Special Type II companies are subject to MPT approval, charges set by General Type II firms are not. Rate "dumping" is reportedly a common occurrence in some market segments.) Firms are focusing increasingly on providing unique software or services in an effort to stay afloat in this cutthroat market. This strategy, however, requires significant human and computer resources that not all firms can afford.

The Defending Champions Respond

Although still criticized as slow-moving mammoths, both NTT and KDD have been trying to adjust to the new situation. In some respects the two titans face restraints. MPT tries to assure, for example, that NTT and KDD both charge at least 20 percent more than private competitors for most services so that the two will not be able to use their still dominant market positions to crush newborn private competitors. In other ways the two have been allowed to meet competitors head-on. By spinning off its data communications operations NTT instantly made NTT Data Communications Systems Corp. a major factor in that market and one of great concern to private competitors; as a subsidiary, NTT Data would be even less subject to MPT regulation than its parent.

KDD - The impact of private competition on KDD's business strategy is unmistakable. By yearend 1986 it was clear that KDD would face two determined private competitors. Although it had been cutting rates since 1979, KDD began to increase the size of the reductions in an effort to nip the competition in the bud. After small reductions of 3 to 6 percent, KDD asked MPT in 1988 for permission to cut rates an unheard-of average of 21.1 percent effective that September -- the sharpest reduction in KDD's history. On November 1, 1989, just one month after ITJ and IDC began handling overseas calls, KDD again cut its rates on all overseas services by an average of 14.3 percent. The consequences for revenues are obvious. After enjoying steady growth since its establishment in 1953 (total sales were up 6 percent in FY 1988 to Y263 billion or $1.9 billion), KDD issued in November revised estimates for the current fiscal year, showing a tiny 1 percent gain in total sales and a 23 percent plunge in expected net profits. It also reported that sales for the first six months of FY 1989 were off 4.5 percent to Y132.1 billion ($943.6 million) and profits were down 36.9 percent to Y18.8 billion ($134.3 million) due to the September 1988 rate slash.

After matching the latest cut, the new private competitors howled that the reduction was unfair; it was too large and came too soon after they had begun full operations, they said. KDD's management has been unrepentant, saying that it already could see customers deserting. It also pointed out that, unlike ITJ or IDC, KDD must maintain full services to unprofitable areas. All three firms know, however, that the price war can go only so far.

KDD, therefore, is focusing on upgrading and diversifying its services. For example, under its Link-plus payment system, KDD acts as an agent for Japanese subscribers in arranging and paying for leased circuits controlled by AT&T and British Telecommunications Plc. KDD also is expanding its digital services in cooperation with AT&T and BT. The three hope eventually to offer a seamless global ISDN network. Moreover, KDD is examining a broad range of individualized services to maintain client loyalty.

NTT - The domestic giant is accelerating changes in the bread-and-butter telephone market. Among its new popular offerings are Free Dial, which is similar to toll-free 800 numbers in the United States; Message Dial, which allows callers to leave recorded messages for others; Dial Q2, an electronic bulletin board service; and Hello Dial, which provides travel, dining and hotel information. In most cases these services are free. NTT clearly is aiming to earn revenue from the increased number of calls rather than from the services themselves.

NTT has advanced by 10 to 15 years its plan to convert the nation's telephone network to a completely digital system. Conversion by the year 2000 would make it possible for NTT to offer ISDN services nationwide. The first wide-area commercial ISDN service, INS-Net 64, became available in the Tokyo, Osaka and Nagoya areas in April 1988. In June of this year NTT greatly expanded its ISDN capacity with INS-Net 1500, a 1.5 megabit-per-second service. By April next year NTT plans to offer INS-Net 1500 in 29 areas around 14 major cities.

NTT also has moved into the VAN market with ANSER (Automatic Answer Network System for Electrical Requests), used in financial transactions, and CAFIS (Credit and Finance Information System), used by credit approval services. It has fine-tuned its F-net facsimile network service, improved its CAPTAIN videotex system and brought out new services, such as HEART (Higher Education Articulation Support System), which provides students with information on colleges and universities.

Diversification plays a major part in NTT's new business agenda. The giant firm has spun out or set up over 130 subsidiaries at home and abroad. While many provide telecommunications-related services, such as the communications consulting service offered to foreigners by NTT International Corp. and the previously mentioned NTT Data Communications, other subsidiaries are completely unrelated to NTT's core business. While these firms help NTT broaden its revenue base, they also help absorb excess employees.

NTT long has been criticized as inefficient and overly bureaucratic. Since 1985 the firm has struggled to reduce its workforce from 314,000. Its 270,000-employee payroll as of September was achieved mainly by not replacing retiring workers (about 9,000 a year) and by transferring 3,600 employees to new subsidiaries. NTT management recently issued a plan to shave another 40,000 workers over the next five years by holding down new hiring and increasing transfers to subsidiaries. Even after this reduction many analysts say NTT still will be inefficient.

Drawing on its well-developed research and development resources (NTT operates a number of laboratories modeled after AT&T's Bell Laboratories), NTT has tried to increase its rate of technological innovation to outpace its new competition. More practical video conferencing equipment, specialized facsimile equipment and smaller, lighter cellular telephones and pocket pagers have been pouring out of NTT's labs. In many cases, however, NTT still finds itself catching up to private competitors that offer innovative foreign equipment (Kansai Cellular Telephone's Micro TAC, for example). NTT has responded by redoubling its research efforts as well as incorporating foreign technology whenever it is advantageous.

In fact, NTT's purchases of foreign products continue to grow, hitting Y41.4 billion ($295.8 million) in FY 1988, a 9.2 percent increase. The gain is actually understated because NTT Data Communications, which was spun out in FY 1988, is a major purchaser of foreign gear. If the purchases of NTT and its subsidiary are combined, the total rises to Y46.8 billion ($334.3 million), a 23.5 percent gain. NTT originally was forced to court foreign suppliers under the provisions of a 1981 U.S.-Japan agreement on NTT procurement. Tokyo renewed the three-year agreement once while NTT was a public monopoly. The privatized NTT extended the pact through the 1987-89 period, and management has indicated a willingness to adhere to the accord after it expires at the end of this year.

Trade in Telecom Gear

The balance between Japan's exports and imports of telecommunications gear has been decidedly in Japan's favor for the past several years, both in overall terms and from a bilateral viewpoint (see Tables 4 and 5). The deregulation of Japan's telecommunications market was supposed to smooth the path for foreigners' sales. The yen's appreciation since September 1985 also was supposed to help by putting a cap on Japan's exports. While imports have grown, exports in dollar terms have shown signs only recently of falling back.

Through 1988 the yen's rise seemed to have no influence on Japanese exports of telecom gear. Exports of nearly every item grew in 1988 in dollar terms compared with the year before. Beginning in 1986, however, imports showed a very positive response to the stronger yen. Because exports are still many times imports, Japan's trade imbalance in this area continues to expand, by a margin of 36.7 percent in overall terms and 30.6 percent vis-a-vis the United States in 1988.

Data for the first seven months of 1989 provide a glimmer of hope. Dollar-demoninated exports are down from the levels recorded in the January-July 1988 period. In some cases the decline is significant, but the nearly across-the-board trimming of exports is equally important. Since imports continued to rise in 1989, the surplus declined. Whether this narrowing will become a trend is unclear.

Frictions

The United States is not alone in its concerns about Japan's telecommunications trade and policy. Europe also has complained, mainly about alleged dumping of telephone equipment and facsimile gear. But frictions with the United States have been on the rise. Briefly, Washington and Tokyo have tangled over the following issues:

Table 4A: Japan's Total Exports of Telecommunications Equipment, 1984-89

(in thousands of dollars*, f.o.b. value)

	1984	1985	1986	1987	1988**	January-July 1988	January-July 1989
Key Telephone Systems	$70,052	$69,129	$68,860	$79,082	$89,026	$49,433	$52,037
Electronic Telephone Switchboards and Exchanges	158,770	179,158	276,459	329,153	419,091	250,502	213,574
Other Telephone Switchboards and Exchanges	21,094	16,103	17,330	7,153			
Desk and Wall Telephone Instruments	165,278	114,669	155,025	103,688	89,157	57,887	48,847
Other Telephone Instruments	175,749	157,355	161,665	218,949	356,943	184,313	138,875
Intercom Systems	16,610	15,858	18,562	18,947	18,493	10,244	9,025
Other Telephone Apparatus	16,619	10,168	7,561	7,263	7,829	4,097	5,189
Telephone Parts	599,764	449,631	586,137	563,663	675,530	385,509	439,468
Current Carrier Line Systems	164,763	270,624	298,741	350,135	529,505	322,054	225,357
Facsimile Equipment	297,061	510,278	719,867	1,611,767	2,811,826	1,497,095	1,561,307
Teleprinters	0	0	0	0	7,729	4,459	2,882
Citizen-Band Radios	21,101	19,224	21,989	21,969	22,644	13,889	4,816
Other Radios	530,077	582,893	770,912	901,320	873,048	506,983	509,706
Radio Telephone Receivers	120,670	131,964	121,003	161,243	235,976	126,722	141,096
Radio Amplifying Tubes	9,199	7,741	9,489	9,220	465	248	195
Radio Parts	1,121,307	1,153,853	1,599,576	1,498,346	918,739	525,275	573,621
Communications Cable	90,690	142,796	177,037	89,416	43,904	24,283	26,494
Optical Fibers	0	0	0	0	159,036	108,621	40,865
Total Exports	3,578,804	3,831,442	5,010,213	5,971,314	7,258,941	4,071,614	3,993,354

Table 4B: Japan's Exports of Telecommunications Equipment to the United States, 1984-89

(in thousands of dollars*, f.o.b. value)

	1984	1985	1986	1987	1988**	January-July 1988	January-July 1989
Key Telephone Systems	$26,871	$28,053	$30,440	$34,054	$21,293	$11,733	$14,523
Electronic Telephone Switchboards and Exchanges	37,908	18,098	23,744	21,464	28,191	17,496	20,332
Other Telephone Switchboards and Exchanges	10,194	941	0	14			
Desk and Wall Telephone Instruments	127,347	80,478	112,491	51,955	25,853	18,059	12,163
Other Telephone Instruments	149,248	123,452	122,021	176,342	248,974	122,195	98,991
Intercom Systems	4,389	5,129	5,147	5,869	5,167	2,715	2,163
Other Telephone Apparatus	9,833	4,639	2,206	2,395	1,860	838	1,742
Telephone Parts	420,953	266,346	309,348	279,809	287,237	171,460	184,254
Current Carrier Line Systems	68,245	152,759	176,567	170,597	319,346	198,707	136,039
Facsimile Equipment	167,267	290,016	253,939	568,385	984,555	487,269	536,496
Teleprinters	0	0	0	0	32	31	0
Citizen-Band Radios	8,058	5,970	6,341	7,389	4,539	3,483	714
Other Radios	247,413	225,748	248,526	340,986	273,858	172,375	139,787
Radio Telephone Receivers	76,416	74,146	53,249	83,547	96,316	54,604	55,395
Radio Amplifying Tubes	2,490	2,118	2,236	2,008	112	46	76
Radio Parts	437,921	427,545	467,222	414,227	244,441	131,951	181,290
Communications Cable	6,215	7,471	11,831	14,525	7,298	4,361	17,882
Optical Fibers	0	0	0	0	95,129	66,852	5,863
Exports to the United States	1,800,768	1,712,909	1,825,308	2,173,566	2,644,201	1,464,175	1,407,710

*The following average annual exchanges rates were used to convert the yen export figures: 1984, Y236.95; 1985, Y240.29; 1986, Y169.99; 1987, Y145.90; 1988, Y128.15; January-July 1988, Y128.89; and January-July 1989, Y135.74.

**In 1988 Japan switched its classification system from the Customs Cooperation Council Nomenclature to the Harmonized Commodity Description and Coding System. Therefore, the product categories for 1988 and 1989 do not always match exactly those for earlier years.

Source: Ministry of Finance, Japan Exports and Imports: Commodity by Country.

Table 5A: Japan's Total Imports of Telecommunications Equipment, 1984-89

(in thousands of dollars*, c.i.f. value)

	1984	1985	1986	1987	1988**	January-July 1988	January-July 1989
Electronic Telephone Switchboards and Exchanges	$7,404	$10,242	$18,507	$38,827	$75,062	$44,574	$63,355
Other Telephone Switchboards and Exchanges	44	125	0	0			
Other Telephone Apparatus	11,433	17,747	20,319	45,564	66,470	36,914	61,213
Telephone Parts	46,860	63,608	83,210	101,570	141,107	74,702	91,742
Current Carrier Line Systems	21,015	26,748	36,898	44,567	67,453	34,376	50,154
Facsimile Equipment	879	2,357	8,030	6,494	5,783	1,483	3,687
Teleprinters	0	0	0	0	460	192	710
Radios Other Than Citizen Band	30,060	9,420	12,915	22,934	30,102	22,774	23,492
Radio Telephone Receivers	0	0	0	0	51,109	31,259	23,353
Radio Amplifying Tubes	4,429	4,555	6,735	6,241	3,223	2,052	1,923
Radio Parts	51,646	68,892	72,286	112,119	220,377	126,704	161,129
Total Imports	173,770	203,694	258,900	378,311	661,146	375,120	480,758

Table 5B: Japan's Imports of Telecommunications Equipment from the United States, 1984-89

(in thousands of dollars*, c.i.f. value)

	1984	1985	1986	1987	1988**	January-July 1988	January-July 1989
Electronic Telephone Switchboards and Exchanges	$6,927	$9,813	$14,799	$33,612	$69,530	$41,935	$56,884
Other Telephone Switchboards and Exchanges	7	4	0	0			
Other Telephone Apparatus	4,365	6,848	3,112	5,224	5,595	2,854	10,925
Telephone Parts	43,253	59,267	78,372	87,435	105,005	59,603	56,309
Current Carrier Line Systems	17,774	23,680	27,076	28,931	50,694	24,356	36,247
Facsimile Equipment	616	1,806	4,444	5,379	4,916	1,229	2,191
Teleprinters	0	0	0	0	252	55	612
Radios Other Than Citizen Band	22,303	6,119	8,201	12,331	13,095	11,177	14,667
Radio Telephone Receivers	0	0	0	0	46,498	29,327	20,884
Radio Amplifying Tubes	3,693	3,603	2,049	3,907	2,799	1,803	1,607
Radio Parts	10,613	13,958	12,943	14,763	120,671	69,609	86,897
Imports from the United States	109,551	125,098	150,996	191,582	419,055	241,948	287,223

*The following average annual exchanges rates were used to convert the yen export figures: 1984, Y236.95; 1985, Y240.29; 1986, Y169.99; 1987, Y145.90; 1988, Y128.15; January-July 1988, Y128.89; and January-July 1989, Y135.74.

**In 1988 Japan switched its classification system from the Customs Cooperation Council Nomenclature to the Harmonized Commodity Description and Coding System. Therefore, the product categories for 1988 and 1989 do not always match exactly those for earlier years.

Source: Ministry of Finance, Japan Exports and Imports: Commodity by Country.

- Trade balance/NTT procurement policy - Despite reduced exports of particular telecommunications items and increased sales of U.S. products to Japan, Washington remains unhappy with the persistent bilateral trade deficit in telecommunications products. Congress, American business leaders and academics have lumped telecommunications equipment with semiconductors, computers and other electronics into a group of technologies critical to America's economic health and national security. Until the trade deficit is narrowed sharply, telecommunications equipment will continue to stir the overall bilateral trade debate.

- Telephone dumping - In response to a complaint filed by AT&T and Comdial Corp. in December 1988, the Commerce Department agreed that the two major Japanese manufacturers of small business telephone systems were selling these products in the United States at unfairly low prices. Commerce's dumping margins for the Japanese suppliers were 137 percent and 179 percent (see JEI Report No. 40B, October 20, 1989). After hearing testimony from AT&T and the foreign manufacturers, the International Trade Commission split 3 to 3 on whether the dumping hurt American makers of key systems and low-end private branch exchanges. Because the petitioner is given the benefit of the doubt when a tie vote occurs, small business systems imported from Japan now will be liable to stiff antidumping duties (see JEI Report No. 45B, December 1, 1989).

Most observers predict that the penalties will not force up prices of low-end PBXs or key systems, both because U.S. distributors hold large inventories and the two Japanese competitors have switched production of all or some of these items to their U.S. subsidiaries. The fact that market-leader AT&T felt compelled to file its first ever antidumping complaint is indicative of the high level of competition. Some Americans decry the growing foreign share of the estimated $44 billion U.S. telephone equipment market as a threat to the nation's long-term economic health.

- Super 301 - Primarily to appease congressional ire over the persistent trade deficit with Japan, the administration cited Japan as a priority country for negotiations under the Super 301 provision of the 1988 trade act (see JEI Report No. 22B, June 9, 1989). The Bush administration listed three areas for negotiations: wood products, supercomputers and satellites. Washington is worried that Tokyo's policy preventing purchases of foreign satellites by government agencies eventually will threaten America's edge in satellite technology (see JEI Report No. 45A, December 1, 1989). Tokyo agreed in 1985 to allow private companies to purchase communications satellites directly from American manufacturers. Both JCSAT and SCC took immediate advantage of this change. Washington says that it has no problem with Japan doing satellite research but that it should give foreigners the opportunity to compete in all segments of the market. Because only a few satellites are needed to saturate the domestic market, some Americans fear that Tokyo is building up a domestic industry to enter the export market.

- Cellular telephones - This subject has surfaced twice in recent years: as part of the 1985 MOSS talks and as a solo in 1989. The latest flare-up actually stemmed from a post-MOSS solution that divided the country into two service zones and allowed only one private competitor and NTT in each zone. The Japanese firm using Motorola equipment wanted to serve users that roamed into the Tokyo-Nagoya corridor. However, MPT was unwilling to allow the crossover by reallocating the necessary radio frequencies. Under pressure from Motorola, which saw a chance to boost its sales in Japan, Washington eventually badgered MPT into allowing limited cross-zone service (see JEI Report No. 26B, July 7, 1989). The resolution of this issue left a sour taste in Tokyo's mouth, however, and could complicate future negotiations.

What Future for NTT

The atmosphere surrounding bilateral telecommunications equipment and services is important because it could influence how Tokyo responds to the five-year review of the law that made NTT a private company. If the law is to be renewed, action must be taken in FY 1990, which starts April 1, 1990. The debate extends beyond the company, however, since any reforms that apply to NTT have a good chance of being applied to KDD as well. Unlike many other policy debates in Japan, this one is taking place in public with several government agencies and private groups participating.

In a nutshell, dissatisfaction with the current situation boils down to NTT's continued domination of the marketplace. Realistically, it would be too much to expect the infant private competition to quickly wrest a significant share of the market away from NTT if for no other reason than it takes time to construct a nationwide communications network. Moreover, some government and private observers fear that NTT will use the dominant position it inherited to relegate private competition to a small portion of the market, eventually leading to market stagnation. Critics still rebuke NTT for being insensitive to customer needs and insufficiently innovative. The proliferation of nontelecommunications subsidiaries also irritates some who feel they divert NTT's attention from its primary responsibilities. In addition, critics charge that NTT has failed to rationalize its operations and cut its overhead costs because it has not really been subjected to sufficiently strong competition.

The debate over NTT's fate really began in 1982 when a government advisory panel's recommendations for reducing the size of the government and making it more efficient included the idea of breaking the giant firm into as many as 10 regional firms. The 1984 breakup of AT&T served as a model, and a warning, when Japanese policymakers drafted the reform that left NTT intact but allowed private firms to enter the market. Denationalization was meant to expose NTT to the forces of competition without causing the chaos and confusion that gripped the American market when AT&T was split into a long-distance provider and several regional service companies.

In some ways, Japanese competitors enjoy advantages their American counterparts do not. Tokyo forces NTT to keep its prices higher than the new carriers so that NTT cannot use its huge resources to overwhelm the new competitors. Japanese consumers were not forced to select a single long-distance carrier during the transition as was the case in the United States. Instead, callers select which carrier they want to use each time they make a call by dialing a special prefix code. Therefore, the level of competition increases, since neither NTT nor the new carriers can lock in customers. Despite all this, NTT (and KDD) continue to hold a daunting share of the market.

Government and private groups studying this situation began issuing reports and recommendations this past summer. Predictably, camps quickly formed at opposite poles with one staking out the middle ground; one side urged that nothing be done, the other advocated radical restructuring and the group in the middle proposed some reforms. What is interesting, however, is the makeup of each group.

The "status quo" group includes Keidanren (the Federation of Economic Organizations, which represents major Japanese companies), the current management of NTT, NTT's labor unions and the Japan Socialist Party, which traditionally has been allied with NTT's unions. Keidanren argues that it is too early to decide whether NTT should be broken up and suggests a three-year hiatus during which the real level of competition can be assessed. In fact, Keidanren members -- composed of a wide range of communications users and providers -- cannot agree over the best path to take at this juncture. Keidanren does feel that NTT and KDD should be allowed to compete against one another in each other's market, something currently prohibited.

NTT's management and workers are happy with the current situation, suggesting that there is sufficient competition from the new common carriers and that breaking up NTT surely would force up the cost of service. The self-preservation instinct is to be expected. The Japan Socialist Party is important to the debate because it controls the upper house of the Diet in a coalition with other opposition parties. Since legislation changing NTT is neither a spending bill nor a treaty (both of which at a minimum need only lower house approval), the upper house's cooperation becomes necessary. With its ties to NTT's unions, the JSP will likely oppose any attempt to radically change NTT.

The middle group includes Japan's Fair Trade Commission and the Japan Telecommunications Industries Federation. Both contend that, while NTT is deficient in certain respects, a breakup is either unnecessary or potentially disastrous. A JFTC report is cognizant of the potential for abuse inherent in NTT's current dominant position and urges some spin off, such as cellular telephone and satellite communications. In addition, it recommends that Tokyo should ensure fair allocation of radio frequencies and that NTT provide full information to private firms about its protocols and standards to ensure equal access. Tokyo also should deregulate the market further to encourage still more competition, JFTC suggests. Nevertheless, JFTC also says that too much competition will confuse consumers and could lead to other forms of abuse. JTIF takes a similar stance, saying that some parts of NTT should be separated out but that preserving efficient nationwide telephone service means NTT should be left basically intact.

The "radical reform" group includes the Ministry of Posts and Telecommunications, the Liberal Democratic Party, NTT's private competitors and some foreigners. MPT argues that the past five years have shown that NTT cannot reform itself. An advisory panel to the ministry has devised three options: divide NTT into several regional entities; bifurcate NTT into a long-distance company and an intracity service company; or carve up NTT into a long-distance company and from two to 11 intracity companies. The panel added that while the last option would give the biggest boost to competition, it also probably would be the costliest and most disruptive. While criticism from the new common carriers is to be expected, the vociferous comments from the LDP are somewhat surprising.

An LDP research council has blasted NTT's failure to streamline its operations, cut costs and pass the benefits on to consumers. NTT also is accused of wasting its time with its broad diversification program. Hiroshi

Mitsuzuka, chairman of the LDP Policy Affairs Research Council, strongly favors a breakup. Pointing to the almost miraculous recovery of the deficit-ridden Japanese National Railways after it was split into several private companies, Mr. Mitsuzuka said a breakup was the only way to bring true competition to the market. A visiting official from BellSouth Corp., one of the regional service firms created by the restructuring of AT&T, added his voice to the radical reform group, saying that the long-term benefits of breaking up NTT -- better service, lower charges, more research and development and more products -- will outweigh the short-term costs.

Other factors complicate the debate as well. Tokyo has pledged to sell up to two-thirds of its NTT shares. Auction of the shares has turned out to be a gold mine for the national treasury and has helped the Ministry of Finance both to cut the budget deficit and finance new spending programs. Beyond the question of how to convert NTT shares into the new shares of post-NTT companies, talk of breaking up NTT has shaken investor confidence in the stock. In the wake of Mr. Mitsuzuka's comments, for example, the price of a NTT share dropped Y30,000 ($214) to Y1.38 million ($9,857). Budget planners, already worrying about how to replace revenues if the unpopular 3 percent general consumption tax is revised, cannot be happy about the possibility that the NTT golden goose will be sold. Another question is: if NTT is broken up, what happens to the U.S.-Japan accord encouraging foreign procurement? Washington would certainly demand something as a replacement, but how can Tokyo force cooperation from private companies that would be created by a breakup of NTT? Further entanglements are posed by the volatile political situation caused by the Recruit Co., Ltd. influence-peddling scandal and the LDP's loss of control of the upper house of the Diet.

Outlook

In many respects Tokyo can be proud of its actions to deregulate and streamline Japan's telecommunications equipment and services market. Private competitors have jumped into nearly every market, and users have benefited from a broader range of services and lower prices. Tokyo realizes, however, that the situation is not optimal; many changes that had been predicted have yet to materialize. For foreign telecommunications vendors, in particular, the Japanese market remains a tough nut to crack. A great deal hinges on the outcome of the debate over NTT's future and whether the LDP can win Diet approval of the necessary implementing legislation.

For further information, contact Jon Choy.

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The views expressed in this report are those of the author and do not necessarily represent those of the Japan Economic Institute.

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JEI REPORT

A Two-Part Report: A and B

NO. 46B
December 8, 1989

IN THIS ISSUE:

LDP, Opposition Parties Gear Up For Lower House Elections 1

LDP Finalizes Tax Reform Plan 3

United States Pushes Japanese Antitrust Enforcement 6

Political Interests At Loggerheads Over Old-Growth Forests 7

Super 301 Discussions Held 9

Notes: Export Controls; Immigration Law 11

Statistical Supplement 13

LDP, Opposition Parties Gear Up For Lower House Elections

Pundits intrigued by the tumultuous nature of Japanese politics during much of 1989 may have found the recent weeks of relative calm sufficient to lull them to sleep. Their slumber may be short-lived, however, judging by the political maneuvering that has begun as the ruling Liberal Democratic Party and the opposition parties try to favorably position themselves for the upcoming lower house elections, probably in late February.

The LDP's special political reform committee issued an interim report November 29 proposing a fundamental revision of the present multiseat representational system and calling for greater transparency in the handling of political funds. Both measures apparently are aimed at helping to restore the public's faith in the ruling party in the wake of involvement by some of its

Japan Economic Institute 1000 Connecticut Avenue, N.W., Washington, D.C. 20036 202·296·5633

members in the Recruit Co., Ltd. graft and influence-peddling affair. In addition, the LDP's tax committee has proposed changes in the unpopular 3 percent consumption tax (see following article), making a down payment on a pledge by Prime Minister Toshiki Kaifu soon after he took office in August.

Prime Minister Kaifu also has been engaged in a series of town hall-type conferences throughout the country. Mr. Kaifu's "Dialogue With the People" is an apparent effort to interact with the populace to dispel the widespread perception that the electorate's wishes were ignored when the ruling party implemented the controverial consumption tax and ceded to U.S. demands that it open Japan's beef and orange markets.

The Japan Socialist Party, the largest opposition party, is bound and determined to follow up its precedent-setting victory in the July upper house contests by usurping LDP control of the more powerful lower house. In the election pledge adopted by the JSP's executive committee November 30, the Socialist Party declared that a new political reality has emerged in Japan as a result of the July elections. The JSP promised to open a "hopeful new page toward the 21st century" by forming a coalition government with the other opposition parties if they succeed in toppling the ruling party from power.

The conventional wisdom appears to be that the House of Representatives probably will be dissolved in late January, with the general election expected to be set February 18 or February 25. (The election must take place some time before July 1990, when the four-year term of lower house members expires.) This possible scenario emerged November 22 after LDP secretary general Ichiro Ozawa met with Prime Minister Kaifu to discuss his planned trip January 8-19 to six countries of Western and Eastern Europe. The prime minister, who is anxious to establish personal relations with the leaders of countries in this dramatically changing part of the world, is expected to visit Poland, Hungary, West Germany, France, Italy and Belgium. Mr. Kaifu no doubt will use this trip to elaborate on Tokyo's recent pledge to provide greater economic assistance to selected Eastern European countries, among other topics (see JEI Report No. 42B, November 3, 1989).

The Diet's current extraordinary session, during which the ruling party had hoped to enact a package of political reforms and possible revisions to the consumption tax, will come to a close on or around December 15. The Diet then will convene December 25 for its 150-day regular session. An early order of business will be the FY 1990 budget. Presumably, the aforementioned legislation also will be on the calendar if no action is taken during the extraordinary session.

Traditionally, however, legislators recess over the Christmas/New Year's holidays and reconvene in late January. Given Mr. Kaifu's travel plans, the parliament probably would get back to business on or around January 22. In view of the fact that the opposition parties are allowed up to three days of interpellation, it would appear that the soonest the LDP-led government could dissolve the lower chamber would be January 25. A Sunday in late February then becomes a plausible election date since legislators typically are given nearly a month to campaign.

Although senior LDP members, such as former deputy prime minister Shin Kanemaru, have suggested that the electorate can expect to go to the polls in

STATISTICAL SUPPLEMENT

Trade and Payments Data

(in millions of dollars unless otherwise indicated)

	1987	1988	January-September 1988	January-September 1989	July 1989	August 1989	September 1989
Japan's Balance of Payments							
Trade Balance	$96,386	$95,012	$67,234	$60,773*	$6,966*	$4,885*	$7,817*
Exports (f.o.b.)	224,605	259,765	188,893	201,555*	22,997*	21,404*	23,649*
Imports (f.o.b.)	128,219	164,753	121,659	140,782*	16,031*	16,519*	15,832*
Current Account Balance	87,015	79,631	56,040	44,981*	5,308*	3,416*	5,910*
Long-Term Capital (net)	-136,532	-130,930	-93,912	-57,316*	-6,752*	-3,503*	-10,648*
Overall Balance	-29,545	-28,982	-29,259	-3,999	-10,839	1,427	8,339
International Reserves (end of period)	81,479	97,662	91,151	86,117	88,865	88,318	86,117
Japan's Customs Clearance Trade							
Trade Balance	79,706	77,563	53,603	50,059	6,008	3,385	7,206
Exports (f.o.b.)	229,221	264,917	192,626	205,483	23,462	21,827	24,316
Cars	35,693	38,671	28,170	29,366	3,208	2,844	3,511
Steel	12,610	15,322	10,948	11,264	1,255	1,209	1,203
Imports (c.i.f.)	149,515	187,354	139,023	155,423	17,454	18,442	17,110
Crude Oil	20,663	18,852	14,825	15,402	1,550	1,867	1,711
Manufactured Products	65,961	91,838	67,405	77,982	8,945	9,332	8,647
Japan-U.S. Trade							
Trade Balance	52,090	47,597	33,326	33,781	3,864	3,020	4,790
Exports (f.o.b.)	83,580	89,634	64,528	69,857	8,097	7,340	8,681
Imports (c.i.f.)	31,491	42,037	31,202	36,075	4,233	4,320	3,892
Yen-Dollar Exchange Rate (average for period)	Y144.64	Y128.15	Y129.11	Y136.27	Y140.72	Y141.11	Y145.05
U.S. Trade							
Trade Balance	-152,119	-118,526	-87,049	-79,558*	-10,730	-10,904	-8,047*
Exports (f.a.s.)	254,122	322,426	237,335	271,352*	28,727	29,610	30,452*
Imports (Customs)	406,241	440,952	324,384	350,910*	39,456	40,514	38,499*
U.S.-Japan Trade							
Trade Balance	-56,326	-52,070	-36,492	-36,610*	-4,043	-3,982	-4,063*
Exports (f.a.s.)	28,249	37,732	27,916	33,036*	3,942	3,933	3,555*
Imports (Customs)	84,575	89,802	64,409	69,645*	7,985	7,915	7,619*

*Preliminary

Japanese Economic Indicators

(percent change from year-earlier period unless otherwise indicated)

	1987	1988	January-September 1988	January-September 1989	July 1989	August 1989	September 1989
Discount Rate (end of period)	2.5%	2.5%	2.5%	3.25%	3.25%	3.25%	3.25%
Outstanding Money Supply	10.4%	11.2%	11.4%	9.9%	9.8%	9.6%	9.6%
Industrial Production	3.4%	9.5%	10.1%	6.7%	5.6%	6.1%	3.9%
Manufacturing Operating Rate	0.1%	5.9%	6.4%	3.0%	1.3%	3.6%	0.3%
Number of Bankruptcies	-27.6%	-20.0%	-21.3%	-25.8%	-23.8%	-29.4%	-21.5%
Residential Construction Starts	22.7%	0.6%	4.5%	-2.5%	-1.7%	-6.0%	0.0%
Job Openings to Applications (ratio)	0.70	1.02	0.98	1.24	1.35	1.32	1.30
Nominal Wages	1.9%	3.8%	3.5%	4.3%	3.7%	4.0%	4.0%
Manufacturing Labor Productivity	5.8%	11.5%	12.4%*	8.5%*	6.1%	n.a.	n.a.
Wholesale Prices	-3.7%	-1.0%	-0.9%	2.2%	3.1%	3.0%	3.3%
Consumer Prices	0.1%	0.7%	0.5%	2.2%	3.0%	2.6%	2.6%
Yen-Based Export Prices	-5.1%	-2.2%	-2.9%	3.9%	3.9%	2.7%	3.8%
Yen-Based Import Prices	-8.3%	-4.6%	-3.8%	5.8%	6.9%	7.1%	8.3%

*Through July of each year only.

For Japan's latest GNP figures, see JEI Report No. 37B, September 29, 1989.

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JEI

REPORT

A Two-Part Report: A and B

NO. 47A December 15, 1989

JAPAN AND SOUTH ASIA

Summary

Japan looks to all of Asia as a region of special interest. The real focal points, however, are Southeast Asia and East Asia, where Japan's foreign aid, trade and foreign direct investment presence are strong, in sharp contrast to South Asia, a region noted for poverty, natural disasters, political instability, military conflicts and border disputes. Nevertheless, for most of the eight countries of South Asia -- home to one-fifth of the world's population -- Japan ranks as a major trading partner and aid donor.

Overview

Conflicting development strategies have kept Japan and South Asia at arm's length. In the 1960s and 1970s Japan was seeking to bolster its economy through export-oriented trade -- importing raw materials and exporting manufactured goods. South Asia has few of these natural resources to sell. Also, regional poverty meant that neither industry nor consumers had the wherewithal to purchase from Japan substantial quantities of capital or manufactured goods. Furthermore, many of the South Asian nations were trying to develop their own manufacturing base through the implementation of import substitution policies and restrictions on foreign direct investment. These inward-looking policies and bureaucratic controls over the South Asian economies made strong interactions with other countries difficult.

As the economies of Japan and South Asia have developed over the past few decades, a growing number of opportunities for trade and investment flourished in the 1980s. Some South Asian economic policies have achieved success, resulting in the development of a middle class with purchasing clout. Similarly, as Japan's economy has grown into one of the world's most powerful, Tokyo's aid programs have increased significantly, benefiting South Asia. Japan also has become cognizant of the importance of assisting countries in strategic locations, including Pakistan, which has been burdened by the flow of Afghan refugees fleeing the war.

Regional Interaction

The countries of South Asia organized themselves in December 1985 under the South Asian Association for Regional Cooperation. The organization's goal is to promote the self-reliance of its members and multilateral cooperation and collaboration in economic, technical, social and cultural areas. Current members include Bangladesh, Bhutan, India, the Maldives, Nepal, Pakistan and Sri Lanka. Afghanistan's application for membership met rejection from all members other than India due to the presence of occupying Soviet military forces. However, in this report Afghanistan is considered part of South Asia in addition to the seven SAARC nations.

The SAARC regional organization was formed in part at the urging of Sri Lanka, whose earlier application for membership in the Association of Southeast Asian Nations had been rejected due to its geographic location. SAARC, designed in part to balance India's predominant position in the subcontinent, attempts to address truly multilateral issues and seeks to avoid involvement in bilateral issues, such as border disputes, water rights and ethnic turmoil. Rather, the organization hopes to address broad-based issues that can promote cooperation, such as rural development, transportation and communications.

Another common bond for much of South Asia is that most of the nations were under the rule or strong influence of the British prior to World War II. Five of the South Asian nations still are members of the British Commonwealth. India and Sri Lanka joined the Commonwealth shortly after the war, respectively in 1947 and 1948. Bangladesh joined in 1972, a year after it declared its independence from Pakistan. The Maldives, a former British protectorate, joined the Commonwealth in 1982, nearly two decades after gaining independence. And Pakistan rejoined the organization in 1989 after having dropped out in 1972 to protest Britain's recognition of Bangladesh.

All of the nations of South Asia, including Afghanistan, also belong to the Nonaligned Movement. The NAM group, which was formed in 1961 and has grown to 101 members, seeks to maintain the sovereignty of its member nations and to combat hegemony, imperialism and racism. The organization originally was concerned about the arms race between the United States and the Soviet Union. As more Third World nations joined, the group condemned imperialism and overseas military bases maintained in former colonies. The concerns of NAM shifted in the 1970s to economic issues that pitted the impoverished Third World against the rich industrialized nations. In conferences since 1983 NAM has focused on Third World debt relief, increased foreign aid and reduction of trade barriers. NAM has been critical of the two hegemons -- the Soviet Union and, much more

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sharply, the United States -- plus Israel's stance on the Palestinian issue and South Africa's apartheid policies.

One troublesome area in South Asia involves nuclear weapons, with both India and Pakistan reportedly having nuclear capabilities. (This is particularly serious since India and Pakistan have fought three wars since independence and both claim the entirety of the partitioned state of Kashmir.) Some of the smaller nations, by contrast, want to ban the presence of foreign nuclear weapons in the region. Over a decade ago Sri Lanka initiated a campaign to have the Indian Ocean declared a "Zone of Peace" -- a move that would prohibit foreign military forces, particularly those with nuclear weapons. Many Japanese may be sympathetic to such philosophies given Japan's World War II experience of being the only country to suffer from an atomic bomb attack. However, while Tokyo adheres to its nonnuclear principles -- no production, no possession and no introduction of nuclear weapons inside Japan -- politicians consider this a touchy subject as far as urging such policies on the South Asian region.

Another area of slight differentiation is in trade matters. In South Asia only Afghanistan, Bhutan and Nepal are not parties to the General Agreement on Tariffs and Trade. During the Uruguay Round of multilateral trade talks both the United States and Japan have pushed for stronger protection in developing countries of intellectual property -- patents, copyrights and trademarks. India and Brazil are considered to be among the chief culprits, whose weak laws lack sufficient intellectual property protection. India also has come under U.S. attack -- under the rubric of the Super 301 section of the Omnibus Trade and Competitiveness Act of 1988 -- for barriers to trade in services, particularly in the insurance industry, and for performance requirements of trade-related investment measures.

Although major powers -- including the Soviet Union and China -- play a role in the region, many conflicts are influenced by India, the strongest of the region's members. Indian forces have been sent to quell fighting by Tamil rebels in Sri Lanka and to help the government in the Maldives resist a coup attempt. But this type of arrangement can be tenuous as the other nations are concerned about Indian dominance in the region. Sri Lanka has had poor relations at times with India, for example, when Tamil rebels moved their headquarters offshore to the Tamil region of India, where many Indians were sympathetic to their cause.

Ensuring stability and promoting economic development are the highest political priorities for the region. In this regard Japan's regional role generally dovetails with U.S. political and security interests. While avoiding direct involvement in most political turmoil in South Asia, Tokyo implicitly has been supportive of many U.S. policies there through, for example, increased aid to Pakistan, which has been used in part to help Afghan refugees who have fled the war. Through its military presence the United States has helped to ensure the continued flow of oil from the Middle East through the Indian Ocean, partially benefiting Japan. Tokyo's contribution towards burdensharing is in the form of foreign aid. That is in keeping with Japan's interpretation of its constitution, which prohibits it from all military activities except maintaining self-defense forces.

Japan's special niche, as it is in other parts of Asia, seems to be as an economic partner and role model. Through economic development the Asian nations believe that they can best assure their sovereignty and increase their clout in multilateral organizations. South Asia, particularly India, is interested in gaining technology from Japan.

Trade - Japan ran a trade surplus of $1.4 billion in 1988 with South Asia (see Table 1). The largest surpluses occurred in trade with Pakistan ($573.6 million) and India ($277.2 million), although Japan ran surpluses with all South Asian countries (see Table 2). The surplus with India represented a continued decline from a 1986 high of $802.4 million, the largest in the region over the most recent five-year period.

Table 1: Japan's Trade by Selected Region, 1988

(in billions of dollars)

Region	Exports (f.o.b.)	Imports (c.i.f.)	Trade Balance
East Asia	$51.2	$32.9	$18.3
Southeast Asia	21.8	22.7	-0.9
South Asia	4.0	2.6	1.4
Middle East	8.4	19.4	-11.0

Source: Japan Tariff Association

Japan's biggest exports to South Asia mirror the product groups heading the list of the country's overall overseas shipments -- nonelectrical machinery, electrical machinery, vehicles and metals. Fish and crustaceans top the list of imports from South Asia, followed by coffee and tea, animal and vegetable oils, and raw hides and skins. South Asia, unlike Southeast Asia and the Middle East, is not a significant exporter of natural resources and is an oil importing region (see Table 3).

Foreign Investment - The investment climate in South Asia generally is not considered to be as favorable as in other Asian locations. Thus, Japanese foreign direct investment levels remain low. Cumulative investment by Japan in India as of March 1989 accounted for a mere 0.1 percent of the total and came to just $148 million (see Table 4). Japan's foreign direct investment in South Asia also was 0.1 percent, scarcely a blip compared with the $13.2 billion invested in East Asia (7.1 percent of the total), the $18.7 billion that has gone into Southeast Asia (10.1 percent) and the $3.3 billion (1.7 percent) funneled into the Middle East.

Political instability and lack of infrastructure are among the most commonly cited reasons for the low investment rates in South Asia. In India rigid regulations on foreign direct investment have proven to be deterrents.

Foreign Aid - Although Japan's trade relations with South Asia are not as strong as with other parts of Asia, Tokyo's official development assistance to South Asia is generous (see Tables 5 and 6). Three of Tokyo's top 10 aid recipients are in this region, and two others round out the top 15. Total aid

Table 2: Japan's Trade Balance With South Asia, 1984-88

(in millions of dollars)

Country	Year	Exports (f.o.b.)	Imports (c.i.f.)	Trade Balance
Afghanistan	1988	$112.6	$2.3	$110.3
	1987	140.6	2.7	137.9
	1986	117.1	1.0	116.1
	1985	97.6	2.1	95.5
	1984	111.9	1.0	110.9
Bangladesh	1988	283.5	84.8	198.7
	1987	357.1	73.5	313.6
	1986	445.2	82.7	362.5
	1985	331.1	84.4	246.7
	1984	243.5	78.3	165.2
Bhutan	1988	4.8	---	4.8
	1987	3.6	0.0	3.6
	1986	5.4	0.0	5.4
	1985	2.1	0.1	2.0
	1984	2.4	0.0	2.4
India	1988	2,081.6	1,804.4	277.2
	1987	1,957.3	1,530.1	427.2
	1986	2,099.4	1,297.0	802.4
	1985	1,596.4	1,188.6	407.8
	1984	1,167.8	1,132.4	35.4
Maldives	1988	10.8	2.3	8.5
	1987	13.0	1.3	11.7
	1986	7.1	1.3	5.8
	1985	12.0	3.5	8.5
	1984	10.3	0.7	9.6
Nepal	1988	61.8	2.3	59.5
	1987	79.3	2.6	76.7
	1986	65.4	1.6	63.8
	1985	61.0	1.1	59.9
	1984	39.4	0.5	38.9
Pakistan	1988	1,126.0	552.4	573.6
	1987	936.1	492.3	443.8
	1986	902.7	352.3	550.4
	1985	786.4	381.6	404.8
	1984	848.9	240.0	608.9
Sri Lanka	1988	286.3	113.4	172.9
	1987	251.2	91.0	160.2
	1986	288.7	89.3	199.4
	1985	270.7	78.6	192.1
	1984	254.1	79.7	174.4

Source: Japan Tariff Association

Table 3: Japan's Trade with South Asia by Top Commodities, 1988

(in millions of dollars)

Afghanistan	
Exports	
Rubber and Rubber Articles	$31.0
Manmade Filaments	22.1
Electric Machinery and Equipment	19.8
Imports	
Oilseeds and Oleaginous Fruits	0.9
Wool and Fine or Coarse Animal Hair	0.7
Mineral Fuels and Oils	0.2
Bangladesh	
Exports	
Metals and Fabricated Metal Products	110.8
Vehicles, Not Including Railway	39.6
Electric Machinery and Equipment	25.7
Imports	
Fish and Crustaceans	59.9
Other Vegetable Textile Fibers	13.8
Raw Hides and Skins	4.0
Bhutan	
Exports	
Vehicles, Not Including Railway	2.2
Nonelectric Machinery	1.7
Steel	0.5
Imports	
None	---
India	
Exports	
Nonelectric Machinery	505.1
Electric Machinery and Equipment	427.4
Metals and Fabricated Metal Products	234.2
Imports	
Natural or Cultured Pearls and Precious Stones	574.3
Iron and Nonferrous Ores	484.3
Fish and Crustaceans	274.9
Maldives	
Exports	
Electric Machinery and Equipment	3.9
Nonelectric Machinery	2.9
Ships and Boats	1.0
Imports	
Fish and Crustaceans	1.3
Coffee, Tea and Spices	0.7
Animal or Vegetable Fats and Oils	0.1
Nepal	
Exports	
Vehicles, Not Including Railway	11.6
Metals and Fabricated Metal Products	10.5
Nonelectric Machinery	7.1
Imports	
Unallocated	0.9
Animal or Vegetable Fats and Oils	0.7
Fabricated Metal Products	0.2
Pakistan	
Exports	
Nonelectric Machinery	351.8
Vehicles, Not Including Railway	304.8
Electric Machinery and Equipment	102.4
Imports	
Cotton and Cotton Fabrics	435.3
Raw Hides and Skins	18.1
Carpets and Floor Textiles	15.3
Sri Lanka	
Exports	
Vehicles, Not Including Railway	73.8
Nonelectric Machinery	46.6
Electric Machinery and Equipment	13.9
Imports	
Natural or Cultured Pearls and Precious Stones	43.6
Fish and Crustaceans	17.7
Coffee, Tea and Spices	13.9

Source: Japan Tariff Association

Table 4: Japan's Foreign Direct Investment by Country, FY 1951-FY 1988

(in millions of dollars)

Country	Cases	Total March 31, 1989	Share of Foreign Investment
East Asia			
Hong Kong	3,164	$6,167	3.3%
South Korea	1,712	3,248	1.7
China	567	2,036	1.1
Taiwan	2,133	1,791	1.0
Southeast Asia			
Indonesia	1,578	9,804	5.3
Singapore	2,239	3,812	2.0
Thailand	1,685	1,992	1.1
Malaysia	1,181	1,834	1.0
Philippines	705	1,120	0.6
Brunei	31	109	0.1
South Asia			
India	151	148	0.1
Middle East			
Saudi Arabia/Kuwait	4	1,383	0.7
Iran	108	1,005	0.5
United Arab Emirates	45	435	0.2
Saudi Arabia	101	369	0.2
Bahrain	22	105	0.1

Source: Ministry of Finance

amounted to $1.1 billion last year. However, Southeast Asia remained the favorite, getting $2.2 billion in total aid from Japan, including $1.6 billion in loans -- a figure far above the $661 million in lending that South Asia received. Unlike much of its foreign aid, Japan's assistance to South Asia in 1988 was split just about 60-40 between loans and grants. Other recipients had a far higher ratio of loans. And compared to Southeast Asia, which received far more technical cooperation aid, South Asia was given more outright grants.

In 1986, the year for which the most recent worldwide data are available, Japan was the top donor to Bangladesh, Bhutan, India, the Maldives, Nepal and Sri Lanka and was the second-largest donor to Pakistan behind the United States. Only Afghanistan among the eight South Asian nations did not qualify as a top recipient. (The United States was the top donor to Pakistan, the second-largest donor to Bangladesh and number three for the Maldives, Nepal and Sri Lanka.)

In 1988 Bangladesh received 3.7 percent of Japan's ODA, which ranked it fifth among recipients (see JEI Report No. 41A, October 27, 1989). Pakistan took sixth place with 3.3 percent. Sri Lanka received 2.2 percent of Japan's

Table 5: Japan's ODA by Selected Region, 1988

(in millions of dollars)

Region	Grants Grants	Grants Technical Assistance	Loans	Total ODA
East Asia	$52.4	$182.7	$494.9	$729.9
Southeast Asia	260.7	342.6	1,593.3	2,196.6
South Asia	370.9	78.1	660.5	1,109.5
Other Asia	---	2.7	---	2.7
Middle East	60.5	48.5	218.1	327.0

Source: Ministry of Foreign Affairs

Table 6: Japan's ODA to South Asia, 1984-88

(in millions of dollars)

Country	1984	1985	1986	1987	1988
Afghanistan	$-0.3	$0.0	---	$-0.4	---
Bangladesh	123.3	121.5	$248.5	334.2	$342.0
Bhutan	1.9	1.6	5.3	4.2	6.8
India	21.6	21.9	226.7	303.9	179.5
Maldives	2.0	2.1	4.3	5.9	16.6
Nepal	28.5	50.7	68.1	76.8	62.4
Pakistan	67.0	93.3	151.6	126.7	302.2
Sri Lanka	63.8	83.7	126.9	118.3	199.8

Source: Ministry of Foreign Affairs

foreign aid monies for eighth place. India rounded out the top 10 getting 2.0 percent of Tokyo's foreign aid. The top 10 U.S. list for 1987 included Pakistan (5th), India (8th) and Bangladesh (9th). West Germany is also a strong donor to the region as the second-largest benefactor of Afghanistan, India, Nepal and Sri Lanka and third-largest to Pakistan.

Country-by-Country Review

Afghanistan - The war that took on international significance with a Soviet invasion in 1979 has torn apart this nation and kept it from maintaining normal relations with other countries. Despite the pullout of Soviet troops during 1988-89, fighting between the Soviet-influenced government in Kabul and mujaheddin rebel forces continues. The factious mujaheddin forces have been unable to score decisive victories in recent months. Yet only winter is expected to slow the fighting. Winter also is expected to hit the 2 million residents of Kabul hard as it did last year when food shortages were rife in the capital. Since the rebels control most of the countryside where food is grown they hope that by limiting food supplies they will weaken resistance. The urban areas have been relying on food shipments from the Soviet Union.

Afghanistan's imports from the USSR were $365 million in 1981 -- the most recent year of comparative data available from the United Nations. Imports from Afghanistan's second-largest supplier, Japan, were only $79 million that year. On the flip side, Japan bought from Afghanistan merely $593,000 worth of goods, ranking it as Afghanistan's number-11 buyer in 1981. The United States, which was Afghanistan's seventh largest importer as well as exporter, bought nearly $10 million worth of Afghan goods. The USSR, the top destination for Afghanistan's goods, bought $421 million. India ranked as its neighbor's third largest trade partner both in terms of imports and exports, U.N. figures show.[1]

Over the past five years the scale of Afghanistan's trade with Japan has remained relatively stable (see Table 2); so has the trade balance. In 1988 exports to Afghanistan of $112.6 million, including rubber and rubber articles, manmade filaments and electrical machinery, far outweighed the $2.3 million of imports comprised primarily of oilseeds, wool and mineral fuels.

This modest trade relationship has not extended to foreign aid in recent years. Tokyo, however, does support the United Nations High Commission on Refugees, which has aided Afghan refugees who have fled the war, primarily to Pakistan. Aid to Pakistan also has increased in recent years.

It is unlikely, given the continued turmoil in the country and the counterplay between the influences of the Soviet Union and the United States, that Japan would choose to become more directly involved in Afghanistan. Tokyo likely will lend support through less political, multilateral channels, such as the United Nations.

Bangladesh - Repeated years of horrendous flooding have destroyed much of the Bangladeshi infrastructure. In what was historically some of the world's worst floods, up to 75 percent of the country was under water in 1988. The severity of the flooding was heightened by deforestation in the Himalayan Mountains. Bangladesh has begun to consider the annual flooding as a regional problem and is looking to cooperate with other countries, such as Nepal and India, for ways to help control the problem. But poor relations with New Delhi may sideline proposals for building dams to control flooding along major rivers that flow between the two countries. Japanese technical and financial assistance could be a key to finding a remedy.

In 1987 Bangladesh bought more goods from Japan than from any other country, while Japan was its third most important shipping destination. Conversely, the United States was the largest purchaser of Bangladeshi exports but ranked third among sellers of imported goods to Bangladesh. Fish and crustaceans are one of the country's main exports. They accounted for more than 80 percent of the $85 million shipped to Japan in 1988 (see Tables 2 and 3). Last year, however, Bangladesh-bound exports dropped to $283.5 million from $357.1 million in 1987. Japan's exports to the country include metals, vehicles and electrical machinery.

Tokyo has increased its aid to Bangladesh significantly since 1986 when 33 percent of the funds Dhaka received in foreign aid came from Japan, the most

[1] 1987 International Trade Statistics Yearbook, Vol. 1 (New York: United Nations, 1989), p. 4.

of any contributor. The $342 million contributed by Japan in 1988 was $93.5 million greater than in 1986 and positioned Bangladesh to be Japan's fifth-largest aid recipient, obtaining 5.3 percent of all Japanese ODA funds. Its average over the 1984-88 period also put Bangladesh fifth, with $1.2 billion and 5.7 percent of the foreign aid disbursed. The country, besides being a top 10 foreign aid beneficiary of Japan, has equivalent status among members of the Development Assistance Committee of the Organization for Economic Cooperation and Development.

Bhutan - Bhutan, a kingdom only slightly larger than Switzerland, began to establish some direct diplomatic relations in 1980 by recognizing its neighbor Bangladesh. Prior to that the British had guided its external affairs and given it economic assistance until 1949 when Bhutan allowed its foreign affairs to be conducted through India. In the mid-1980s Bhutan went on to establish diplomatic ties with several European nations. Official links with Japan were launched during the 1986-87 period. Bhutan still conducts many of its political affairs through India as well as through the United Nations.

Although Bhutan ranks as one of the poorest countries in the world, some analysts believe that, going by such other criteria as basic needs being met, Bhutan is better off than some of its neighbors.[2] Bhutan does not face the problems of overpopulation, skewed land distribution or underemployment. Average daily caloric intake levels are higher than those of its neighbors.

Japan was Bhutan's largest donor of foreign aid in 1986, providing $5.3 million or 38.4 percent of that country's total aid. Last year Bhutan received $6.8 million in assistance from Japan.

Japan's trade with Bhutan is minimal, the lowest of any country in the region. Imports are insignificant, while exports in 1988 of vehicles, machinery and fabricated steel products contributed to a $4.8 million trade surplus for Japan.

India - India's traditional links with British interests have been subsiding since the country became an independent member of the Commonwealth in 1947. In 1989 trade and foreign aid linkages with Japan and the United States are stronger than they are with Britain. Japan's exports to India have remained steady for the past three years and totaled $2.1 billion in 1988. Imports from India, however, have continued to edge upward, totaling $1.8 billion last year. The 1988 trade surplus of $277 million was a sharp decline from the previous year's $427 million. Bilateral trade surpluses have been quite erratic, ranging from a five-year low of $35 million in 1984 to a high in 1986 of $802 million. In 1981 the United States bought the most goods from India; Japan's purchases ranked fifth. Exports to India that year put the United States second, behind the Soviet Union, with Japan following closely in third place. Japan's top shipments last year consisted of nonelectric and electric machinery and metals. Japanese buyers favored pearls and precious stones, ores and fish and crustaceans from India.

India is the only country in South Asia with any significant Japanese direct investment. Cumulative investment through March 1989 totaled $148 million or 0.1 percent of Japan's overseas direct investment. Among Japanese

[2] Sukhdev Shah, "Developing Bhutan's Economy: Limited Options, Sensible Choices," Asian Survey, Vol. XXIX, No. 8, August 1989, p. 816.

firms with joint ventures in India are such electronics giants as Toshiba Corp., Hitachi, Ltd. and Mitsubishi Electric Corp. As a result of economic liberalization efforts under former Prime Minister Rajiv Gandhi in the mid-1980s economic growth accelerated and consumer demand increased greatly, particularly for color televisions. Japanese manufacturers of color television tubes in India expect sales to double in the next two years to more than 2 million per year. Another aspect of production in India that intrigues Japanese manufacturers is the possibility of increasing sales to the Soviet Union and Eastern Europe through India, which already has well-established trade ties with these regions. Low wages and a relatively well-educated workforce have not yet proven enough of an attraction to Japanese firms to entice them to produce in India for other export markets in the face of what they see as overregulation and bureaucratic inefficiency.

Japan's aid to India has seesawed, dropping in 1988 to $180 million from $304 million in 1987, although far higher than in 1984 and 1985 when transfers were $22 million each year. (The 1986 figure of $226.7 million provided a bridge to the larger outlays in 1987.) Nevertheless, India was ranked as Japan's seventh largest recipient of ODA for the 1984-88 period, receiving $754 million or 3.7 percent of Japan's total ODA. The 1988 sum made India Japan's ninth largest beneficiary with 2.8 percent of the total. In 1986 Japan was India's largest single donor, providing 22.3 percent of its foreign aid income. The previous year's top donor, the United Kingdom, contributed only 16 percent of India's funds in 1986.

Recent elections brought an end to the Nehru-Gandhi political era and brought Vishwanath Pratap Singh to power as prime minister. Mr. Singh was formerly finance minister during the period of economic liberalization at the beginning of Mr. Gandhi's term. Analysts are hopeful that Mr. Singh will be able to continue economic reforms and also resolve the bloody Punjab conflict between Sikhs and Hindus. While the U.S. Congress is quite concerned about the human rights violations reported in Punjab, Japan has assumed a hands-off approach to the internal Indian dilemma. The new prime minister is not expected to assume a dramatically different approach to foreign affairs.

Maldives - The Maldives gained independence in 1965 after having been a British protectorate and became a member of the Commonwealth in 1982. Fish and processed fish products account for 95 percent of its exports, which go primarily to Japan and Sri Lanka. In 1988 the Maldives shipped $1.3 million worth of fish and fish products to Japan. Other goods sold to Japan included coffee and tea and animal and vegetable oils. Major purchases from Japan included electric and nonelectric machinery and boats. Tourism counts as a major draw for foreign currency (the Maldives often is packaged as a honeymoon destination for young Japanese couples), but recent unrest in Sri Lanka by Tamil separatists, particularly bombings at the Colombo airport -- the gateway to the Maldives, has discouraged some tourists. A failed coup attempt in the Maldives last year also has tarnished its appeal.

Japanese aid to the Maldives took a significant jump from $5.9 million in 1987 to $16.6 million last year. More than $15 million of the funding was in the form of a grant. Although worldwide aid statistics for these years have not been compiled, Japan obviously is one of the top contributors to the Maldives. In 1986, when Japan gave the Maldives $4.3 million in ODA, that amount was sufficient to earn Tokyo the top donor spot, contributing 38.1 percent of the Maldives' foreign assistance. The U.S. portion accounted for less than 9 percent that year.

Nepal - Nepal, like Bhutan, is among the world's dozen poorest countries. Its trade relationship with Japan has followed a Third World pattern of buying manufactured goods and shipping food or low-value products. In 1988 Nepal bought $61.8 million of goods from Japan, primarily vehicles, metals and machinery. Its $2.3 million in Japan-bound cargo consisted largely of animal or vegetable oils and metal products.

In 1988 Japan's ODA to Nepal reached $62.4 million, of which 90 percent was in the form of grants and technical assistance. The figures for 1986 show Japan as Nepal's top donor, giving $68.1 million or 40 percent of its total foreign aid. In comparison, the United States gave only 10 percent of Nepal's total outside assistance that year.

Pakistan - After the death of General Mohammad Zia ul-Haq in 1988, Benazir Bhutto and the Pakistan People's Party swept to power. Ms. Bhutto has ruled with the support of a coalition and overcame a major hurdle as she survived a no-confidence vote in the fall of 1989. A popular leader internationally, Ms. Bhutto faces difficulties at home as Pakistanis clamor for more rapid economic change. The military is still extremely powerful and consumes most of the national budget.

On the trade front Pakistan's interaction with Japan has continued to increase, but slowly, over the past five years. Japan's exports to Pakistan topped the $1 billion mark in 1988 for the first time, coming in at $1.1 billion. Imports from Pakistan, at $552 million, were roughly half the outbound cargo. Pakistan buys Japanese machinery and vehicles, while sending out cotton and cotton fabrics, raw hides and skins, and carpets.

Japan's foreign aid to Pakistan more than doubled in 1988, hitting $302 million, up from $127 million in 1987. The increase boosted Pakistan to the number-six position on Tokyo's list of recipients and accounted for 4.7 percent of total Japanese ODA funds. During the 1984-88 period the country received an average of 3.6 percent of Japan's foreign assistance, making it the eighth largest recipient with $740.8 million. The 1986 international comparison shows Tokyo as the second-largest single donor behind Washington. In 1986 the United States gave 31.8 percent of Pakistan's total aid while Japan's $152 million contribution accounted for 24.8 percent.

Sri Lanka - Despite its size and ethnic conflicts Sri Lanka has a higher level of foreign trade relative to its gross national product than other South Asian nations. Japan's 1988 exports of $286.3 million to Sri Lanka came close to its 1986 level, $288.7 million, after dipping in 1987 to $251.2 million. Sri Lanka's main purchases were vehicles and nonelectric and electric machinery. Natural resources figured as Sri Lanka's major exports to Japan, crowned by pearls and precious stones, then fish and crustaceans, coffee and tea.

Sri Lanka placed eighth among Japanese aid beneficiaries in 1988, receiving $199.8 million, and tenth overall for the 1984-88 period. The country received just over 3 percent of Japan's ODA in 1988 and averaged just under 3 percent for the five-year period in which aid totaled $593 million. As might be expected Japan was Sri Lanka's single largest donor in 1986, contributing nearly 33 percent of all its overseas aid that year.

Conclusion

South Asia is likely to remain a region of secondary interest to Japan. Tokyo, however, is expected to continue to have a strong regional presence in terms of foreign aid. Japan may be able to take a lead in helping to develop infrastructure in some countries and to assist in finding solutions to flooding, deforestation and other natural disasters, which, until controlled, will limit the abilities of the populace in improving the region's economies significantly. Strong potential exists for foreign investment in the region, where labor costs are low. Problems of overregulation and political instability remain, however, and deter major investments. As these countries develop, trade ties could strengthen. The region would like to gain technology and manufacturing expertise from Japan. But in the near future Japan is likely to focus instead on importing raw materials from the Middle East and Southeast Asia and manufactured products from newly industrialized countries.

For further information, contact Gretchen Green.

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The views expressed in this report are those of the author and do not necessarily represent those of the Japan Economic Institute.

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IN THIS ISSUE:

Japanese GNP Rebounds 1
Proposed FY 1990 Budget Up 9.7 Percent 4
Congress Adjourns, Leaves Back Burners On 6
FSX Project Finally May Get Off The Ground 7
Burdensharing Provisions Enacted Into Law 9
White House Steel Program In Place 10
Notes: Forklifts 12

Japanese GNP Rebounds

Analysts widely agree that the Japanese economy is among the industrial world's strongest, but the latest gross national product figures looked impressive even by that standard. In the July-to-September period real GNP jumped an astonishing 12.2 percent on an annual basis (see Table). Analysts had to reach back 16 years to the period of Japan's most rapid economic growth, just prior to the first oil shock in 1973, to find a higher quarterly figure. The most recent performance seemed about as remarkable, if not as impossible, as a middle-aged track star equaling the best performances of his youth.

But, on closer inspection, the figures were less impressive. The numbers for the previous quarter had been dismal; inflation-adjusted GNP actually dropped 3 percent on an annual basis, a result attributed to the April 1 introduction of the new consumption tax. But the effect of the tax on the latest figures may even have been slightly positive. For example, the consumption tax resulted in a lower average tax on cars; car sales have continued to increase

Japan's Real Gross National Product at Constant (1980) Prices

(in billions of yen, seasonally adjusted, quarterly totals and rates of growth at annual rates)

	FY 1987	FY 1988	October-December 1988	January-March 1989	April-June 1989	July-September 1989
Gross National Product	Y318,109.2 (5.4%)	Y334,968.8 (5.3%)	Y337,203.3 (4.7%)	Y343,155.4 (7.2%)	Y340,561.8 (-3.0%)	Y350,520.9 (12.2%)
Personal Consumption Spending	176,556.3 (4.5%)	185,317.8 (5.0%)	185,932.0 (3.0%)	188,458.9 (5.5%)	186,600.8 (-3.9%)	190,316.3 (8.2%)
Private Residential Construction	19,653.9 (25.7%)	20,686.8 (5.3%)	21,241.7 (12.1%)	21,341.2 (1.9%)	20,855.0 (-8.8%)	21,340.1 (9.6%)
Private Fixed Nonresidential Investment	61,897.9 (10.1%)	72,617.1 (17.3%)	73,117.5 (13.2%)	77,820.6 (28.3%)	78,320.0 (2.6%)	84,033.5 (32.5%)
Change in Business Inventories	1,618.0 (*)	2,080.6 (*)	2,362.2 (*)	1,080.4 (*)	2,463.2 (*)	1,815.1 (*)
Government Current Expenditures	28,697.2 (-0.6%)	29,341.5 (2.2%)	29,461.4 (3.3%)	29,647.9 (2.6%)	29,650.4 (0.0%)	29,727.0 (1.0%)
Government Fixed Investment	24,335.8 (9.4%)	24,621.6 (1.2%)	24,542.9 (0.6%)	24,674.3 (2.2%)	24,540.4 (-2.2%)	24,214.0 (-5.2%)
Change in Government Inventories	46.1 (*)	-185.0 (*)	-879.0 (*)	261.2 (*)	371.8 (*)	63.4 (*)
Net External Sector	5,304.1 (-33.7%)	488.4 (-90.8%)	1,424.7 (235.3%)	-129.0 (*)	-2,239.8 (*)	-988.5 (*)
Exports of Goods and Services and Factor Income Received	55,507.1 (5.4%)	61,457.7 (10.7%)	62,093.4 (4.0%)	66,337.7 (30.3%)	65,824.7 (-3.1%)	69,636.2 (25.3%)
Imports of Goods and Services and Factor Income Paid	50,203.0 (12.4%)	60,969.3 (21.4%)	60,668.7 (2.2%)	66,466.7 (44.1%)	68,064.5 (10.0%)	70,624.7 (15.9%)

*Cannot be calculated or meaningless.

Source: Economic Planning Agency

while sales of goods and services adversely affected by the new tax have stabilized, at worst, at lower levels. The latest results, in which private consumer spending rose an annualized 8.2 percent after a 3.9 percent drop on a full-year basis in the April-June quarter, suggest that on balance the economy has shaken off the negative results of the consumption tax almost completely. The latest surge appears to restore the economy to its previous growth trajectory.

As in the past the single most impressive GNP component was private plant and equipment spending, which rose an annualized 32.5 percent, returning to earlier robust growth rates after eking out a modest gain in the second quarter. This category alone accounted for 1.7 percentage points of the 2.9 percent quarterly growth. With the latest increase capital spending came to 19.7 percent of nominal GNP, the highest figure since the early 1970s for Japan and substantially above the U.S. percentage. Such results will do little to quiet U.S. critics who fear a renewed export surge as the investments enhance the international competitiveness of the Japanese economy (see JEI Report No. 44B, November 17, 1989). Japanese government officials respond that the investments generally do not add to capacity and, when they do, are directed primarily at satisfying domestic demand.

In contrast to the previous two quarters the foreign sector increased the overall growth rate slightly in the July-September period. The contribution came to 0.4 percentage point compared to a negative 0.6 point in the previous quarter. The latest figure suggests that, once seasonal factors and price changes are taken into account, Japan's external imbalance grew during the quarter. Analysts explain that increases in Japan's income from foreign investments were the reason for the growth; if only exports and imports of goods and services had been considered, the contribution of the foreign sector would have continued in the negative column.

The remaining sectors were notable for their sluggishness despite the high overall rate of growth. Housing, inventory accumulation and public spending collectively shaved 0.3 percentage point off the quarterly growth rate. While inventories (and their growth rate) typically exhibit little sustained pattern and housing expenditures have shown a mixed pattern in recent quarters, the slow rates of growth in government spending in the third quarter on top of equally restrained expansion in previous periods is arguably of more significance. Public spending for investment, consumption and inventories has shown a slow but fairly consistent decline as a share of GNP in recent years, shrinking from 17.5 percent of total nominal GNP in fiscal 1984 to 15.9 percent in FY 1988 and to 15.6 percent in the July-September quarter. These figures in part reflect Tokyo's continuing -- and successful -- effort to rein in government spending.

Despite the temptation to draw a parallel with 1973 GNP growth rates -- which were accompanied by accelerating inflation -- Economic Planning Agency officials and other analysts expressed little concern that the latest quarterly figures indicate overheating of the Japanese economy. They noted that the growth rate from the third quarter of 1988 came to a real 5.1 percent, suggesting that the quarter-to-quarter bumps in the figures even out over longer periods of time. The expansion is expected to continue in the October-December period; that will make the government's official outlook for 4 percent growth in FY 1989 appear to be within easy reach. Many private analysts actually would add about 1 percentage point to that figure. In short, while the Japanese economy may be incapable of the sustained sprints of its youth, it remains remarkably healthy in middle age.

Douglas Ostrom

Proposed FY 1990 Budget Up 9.7 Percent

Japan's general account budget for FY 1990 will reach Y66.3 trillion ($473.6 billion at Y140=$1.00), an increase of 9.7 percent over the initial budget for the year through March 31, 1990, according to a Ministry of Finance draft. This growth, fueled by a massive tax windfall due to the robust expansion of the economy, would be the largest since FY 1981 when the initial budget increased 9.9 percent. A 5.6 percent gain is penciled in for discretionary expenditures compared with a 3.3 percent rise during the current fiscal year and no growth between FY 1983 and FY 1987, while transfers to local governments tentatively are set to expand 15.2 percent. Equally important, the bigger budget will allow the government to redeem Y2.7 trillion ($19.3 billion) of the outstanding debt, which is expected to total Y161 trillion ($1.2 trillion) by the end of March 1990. The Ministry of Finance estimates, however, that if the initial requests from all government ministries and agencies were to be met, the expected Y66.3 trillion ($473.6 billion) in FY 1990 revenues would be short by Y0.7 trillion ($5 billion). Therefore, each ministry and agency is meeting with MOF to figure out spending priorities before the government's budget plan is submitted to the Diet, probably at the end of December.

The biggest revenue increase will come from the tax windfall expected if the economy grows at a projected 4 percent real rate in FY 1990. Analysts in the ruling Liberal Democratic Party and in the business community repeatedly have criticized the Finance Ministry for assuming too low a growth rate and, as a result, underestimating tax revenues. For the upcoming fiscal year MOF forecasters are projecting tax revenues at Y58 trillion ($414.3 billion), a hefty 13.7 percent increase over the initial FY 1989 budget (see Table).

In FY 1990 government bond issues will be limited to construction bonds used to finance public works, thus fulfilling the government's pledge to eliminate new issues of deficit-financing bonds by FY 1990. Reliance on construction bonds and a special scheme for promoting social infrastructure projects -- financed by the sale of government-held shares of Nippon Telegraph and Telephone Corp. -- will remain about the same as in the FY 1989 budget. The Finance Ministry contends that Japan's economic and social infrastructure is being upgraded according to plan and does not need to be increased by the amount urged by Washington (see JEI Report No. 44B, November 17, 1989).

Requests for discretionary spending in FY 1990 currently total Y36 trillion ($257.1 billion) compared with late summer requests of Y35.1 trillion ($250.8 billion) (see JEI Report No. 35B, September 15, 1989); the addition stems from proposed wage increases for public employees and other costs. Tough MOF negotiators are expected to trim the extraordinarily high 5.6 percent increase to keep total expenditures in line with total revenues. Although MOF and other ministries and agencies still are working out the details of the initial budget, defense spending and foreign aid funding are certain to go up by above-average percentages. This follows similar past responses to international requests and contrasts somewhat with Tokyo's policy of keeping expenditures for

FY 1990 Budget Plan

(in billions of yen)

	Initial FY 1989 Budget	Planned FY 1990 Budget	Change
Revenues			
Tax Revenues	Y51,010.0	Y58,000.0	13.7%
Other Revenues	993.2	1,200.0	20.8
Receipts from NTT Stock Sale	1,300.0	1,300.0	0.0
Public Bonds	7,101.0	5,800.0	-18.3
Construction	5,780.0	5,800.0	0.4
Deficit-Financing	1,331.0	0.0	-100.0
Total	60,414.2	66,300.0	9.7
Expenditures			
Discretionary Expenditures	34,080.5	36,000.0	5.6
Transfers to Local Governments	13,368.8	15,400.0	15.2
Social Infrastructure	1,300.0	1,300.0	0.0
Debt Service	11,664.9	14,300.0	22.6
Interest Payments	11,664.9	11,600.0	-0.6
Debt Consolidation Fund	0.0	2,700.0	---
Total	60,414.2	67,000.0	10.9

Source: Ministry of Finance

public works at FY 1989's level. MOF's view is that public spending should have a neutral impact on the economy; more fiscal stimulus, it believes, might kick off inflation.

The central government is required by law to transfer 32 percent of three national taxes to local governments. The projected amount in FY 1990 will be a record-high Y15.4 trillion ($110 billion), a benefit of the current economic boom.

Debt service, showing a 22.6 percent jump over the present budget, consists of two parts -- interest payments and money for the debt consolidation fund. For the past eight years the government has made no payments to the fund as it used all receipts to limit the need for deficit financing beyond the huge amounts it already was borrowing. To redeem the outstanding debt, the law requires the government each year to allocate general account funds equal to one-sixtieth (1.67 percent) of the total outstanding debt for the debt consolidation fund. By resuming payments Tokyo will be taking the second step toward getting its fiscal house in order since the fund helps decrease the towering debt outstanding and lessens the weight of annual interest payments.

The government will submit a FY 1989 supplementary budget of Y5.1 trillion ($36.4 billion) to the regular Diet session that starts in late December. According to this plan, Y800 billion ($5.7 billion) of this fiscal year's projected Y1.3 trillion-plus ($9.5 billion) worth of deficit-financing bonds will not be auctioned off since buoyant tax revenues have reduced the need for government borrowing. In addition, Y1 trillion ($7.1 billion) will be allocated to the debt consolidation fund. Furthermore, Y1 trillion ($7.1 billion) will be deposited in the government's pension fund to make up for payments deferred between 1986 and 1988. The remainder of the supplementary budget will be earmarked for various expenditures, such as planned aid to Eastern Europe. The attention being paid to retiring the outstanding debt underscores the fact that Japan is trying to get its fiscal house in order to meet the fiscal demands of an older society in the next century.

Hideo Takahashi

Congress Adjourns, Leaves Back Burners On

Congress adjourned November 21 just in time for the Thanksgiving holiday, after pushing through a stripped-down, must-pass deficit reduction package. Capitol Hill was preoccupied by the budget this session. Trade remained on the back burner since Congress did not seem anxious to consider new trade bills so soon after finishing a major piece of legislation, the Omnibus Trade and Competitiveness Act of 1988. Wary that new trade bills might indicate a lack of confidence in the trade act and weaken the threats of action under the new law, representatives and senators merely monitored trade progress through hearings on the Super 301 section of the trade act, the Uruguay Round of multilateral trade talks and possible ramifications of the economic integration of the European Community in 1992. Instead of focusing on trade as the last Congress did, legislators this year turned to other themes, including the bolstering of U.S. competitiveness in business, technology and education.

Another recent popular theme on Capitol Hill -- foreign direct investment -- found its way into a number of measures of the final version of the deficit-reduction bill (see JEI Report No. 42B, November 3, 1989). Several proposals affecting foreign-owned companies were retained, while others were dropped. Among the provisions kept was a measure that would increase tax reporting requirements to the Internal Revenue Service for American companies controlled by foreign owners. This provision is designed to increase compliance with U.S. tax law, but critics charge that it will discourage foreign investment by overburdening foreign-affiliated firms.

Another foreign investment-related measure included in the deficit-reduction bill will change the tax treatment of intracompany loans for foreign subsidiaries. Loans now will be calculated at the market rate at which U.S. firms must borrow capital. This provision seeks to neutralize the possible advantages gained by foreign-affiliated subsidiaries that can borrow overseas from their parents at lower interest rates. In Japan, for example, interest rates on loans are lower than in the United States.

Among the investment-related measures that fell by the wayside was a House provision that would have taxed the gains from the sale of stock by nonresident investors who owned 10 percent or more of a company's shares. Another scrapped proposal would have changed the tax treatment of expenditures for research and development that occurred outside the United States (deferring deductible expenses over a five-year period); the goal here was to encourage more R&D in America. In the next session some of these provisions may be reintroduced, and measures already passed may be fine-tuned through technical corrections. The broader issue of foreign direct investment -- such as legislation distance of 1,000 nautical miles to the south and east. Tokyo also is urged to buy more off-the-shelf military equipment and weapons systems from the United States.

- Host nation support - PL 101-189 requires the administration to negotiate with Japan to achieve Japanese security contributions equal to 100 percent of the direct costs of maintaining the U.S. forces that defend the country. (Tokyo currently provides about 40 percent of the $6 billion cost of maintaining U.S. forces in Japan.)

With Japan's defense spending currently hovering at 1 percent of GNP, its foreign aid expenditures at about 0.32 percent and the NATO combined figure averaging 3.7 percent, these provisions envision substantially reordered Japanese budget priorities in the next two years. Concerning the host nation support demands, in particular, Tokyo maintains that it would be forced to exceed the legal limitations of the 1960 Status of Forces Agreement. SOFA, which spells out the costs that the United States and Japan each should bear to support the American troop presence, provides that the United States "will bear for the duration of this agreement without cost to Japan all expenditures incident to the maintenance of the United States armed forces in Japan," except for certain specified exceptions.

Tokyo maintains that payments for utilities, road maintenance, ship repair and so forth -- costs that some American legislators believe Japan should bear -- would exceed these statutory limitations. Thus, if the United States wants Japan to bear these additional costs, SOFA would have to be amended, Japanese government officials have insisted (see JEI Report No. 38A, October 6, 1989). And, in light of the tough test that the ruling Liberal Democratic Party is about to face in the upcoming lower house elections, Tokyo would prefer not to broach this potentially controversial matter in the immediate future.

Reacting to the Senate's action, chief cabinet secretary Mayumi Moriyama said November 16 that the Kaifu administration will "act independently" from the new law, perhaps reminding Congress and the White House that they cannot dictate Japan's policies. However, she indicated that Tokyo is open to discussing with Washington the possibility of greater Japanese outlays to support U.S. forces in Japan. Japan Defense Agency Vice Minister Seiki Nishihiro concurred that bilateral talks on this subject are in order.

Barbara Wanner

White House Steel Program In Place

The Bush administration has wrapped up phase one of its plan to open steel markets both here and abroad. On December 12 U.S. Trade Representative Carla Hills announced that Washington had hammered out agreements with Japan, the 12-nation European Community and five other countries to end practices that distort world trade in steel. These pacts, the White House hopes, will be stepping stones to an international accord limiting government intervention in the steel sector. At the same time the chief U.S. trade negotiator confirmed the outlines of the arrangements worked out with Japan and the EC, this country's top foreign steel suppliers, and 15 second-tier exporters to restrain U.S.-bound steel shipments through March 1992.

The "historic" bilateral agreements to eliminate trade-distorting steel practices vary in detail but have the same thrust, administration officials say. The accords commit the governments of Japan, the 12 EC countries, South Korea, Brazil, Mexico, Australia and Trinidad and Tobago to stop subsidizing the production and sale of steel, whether for export or use at home. Exceptions to this broad restriction are limited to government support for environmental expenditures, research and development, worker retraining and plant closings. The signatories also agreed to improve foreign access to their steel markets by lowering and/or ending tariff and nontariff barriers.

Even allowing for the waivers they received for certain types of government support, EC countries and the three newly industrialized economies will have to make changes, some major, to live up to their commitments to end steel subsidies that skew international competition. Japan, in contrast, is home free. Although there has been periodic talk in U.S. steel industry circles about Japanese dumping, no one in recent years has accused Tokyo of subsidizing domestic steelmakers or providing financial assistance for exports. Moreover, the pledge to reduce and remove duties on foreign steel should not be hard for Japan to meet since Japanese mills now have little (3.9 percent or 4.6 percent at most) tariff protection from imports. The industry might drag its feet about duty-free trade in steel, but the fact remains that Japanese manufacturers no longer are competitive in the huge commodity end of the market.

What the nontariff barrier part of the agreement might mean for Japanese mills is harder to ascertain without knowledge of the still-confidential specifics of the pact. Neither the government nor the industry has a problem with the drive to end NTBs as normally defined by international economists because these government-erected obstacles to imports already have been eliminated. The main unknown is whether Tokyo agreed to stop trade practices that Washington early on in the negotiations cited as "discriminatory and restrictive," such as Ministry of International Trade and Industry administrative guidance to steel makers (see JEI Report No. 32B, August 18, 1989).

Where the Japanese steel industry could be pinched is on future shipments of high value-added products to the United States since it came up short on quota allocations for the October 1989-March 1992 period. The previously disclosed rollback in Japan's access to the American market (see JEI Report No. 41B, October 27, 1989) still troubles government and industry officials. While acknowledging that mills will have trouble shipping the overall allowable tonnage, they feel that Washington changed the ground rules for divvying up import shares after the fact. Tokyo is more than willing to work with the United States in the Uruguay Round of multilateral trade negotiations to achieve an international agreement that tackles the causes of distorted world trade in steel. That, according to the Bush administration, was supposed to be the trade-off for favorable quota consideration. Yet even with Tokyo's almost spotless record on trade-distorting steel practices, Japan, alone among the participants in the White House's steel restraint program, had its shipment ceiling lowered (see Table).

The cutback in Japan's quota is even greater than first reported because of differences between the product coverage of the current restraint program and the one in effect from October 1984 to September 1989. The old arrangement limited shipments of finished carbon steel mill products. Sales of semifinished

Import Share of U.S. Steel Market, October 1989-March 1992*

Country	Old Restraint Arrangements Adjusted	New Restraint Arrangements		
		First Period	Second Period	Third Period
Australia**	0.26%	0.39%	0.49%	0.59%
Austria	0.24	0.25	0.25	0.25
Brazil**	1.35	1.80	2.10	2.10
Czechoslovakia	0.04	0.04	0.04	0.04
EC**	6.94	7.00	7.00	7.00
Finland	0.24	0.25	0.25	0.25
East Germany	0.11	0.10	0.10	0.10
Hungary	0.03	0.05	0.05	0.05
Japan**	6.19	5.00	5.30	5.30
South Korea**	1.92	2.45	2.62	2.62
Mexico**	0.49	0.95	1.10	1.10
PRC	0.08	0.08	0.09	0.09
Poland	0.09	0.13	0.13	0.13
Romania	0.11	0.11	0.11	0.11
Trinidad and Tobago**	0.04	0.12	0.13	0.15
Venezuela	0.21	0.33	0.33	0.33
Yugoslavia	0.02	0.05	0.05	0.05
Total	18.36	19.10	20.14	20.26

*Numbers are approximate because some arrangements were negotiated for two 15-month periods, and others were negotiated for other combinations totaling 30 months. Market shares are based on 1989 apparent consumption.

**Includes bonus awards.

Source: Office of the U.S. Trade Representative

steel were capped but on a volume basis, not as a share of expected U.S. demand, while exports of specialty steel by countries other than the EC and Brazil were restricted under a separate program that ran through September 1989. Adjusting Japan's previous market share for these product categories, which are included in the Bush administration's program, ups the figure from 5.8 percent to 6.19 percent. Now Japanese steel producers can supply only 5 percent of the the American market, although their access increases to 5.3 percent in January 1991.

U.S. trade negotiators say that the drop in Japan's market share simply reflects the fact that the world's biggest steel-exporting country was able to fill only 72 percent of its quota last year. Reallocating part of the unused portion to other suppliers, particularly low-cost Third World producers, should increase the total amount of foreign steel available to domestic users, they add. At the same time expanded import competition should help U.S. mills prepare for the post-March 1992 period, when the American steel market will be reopened.

Susan MacKnight

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ENVIRONMENTAL ISSUES IN JAPAN: THE DOMESTIC DIMENSION

Summary

To many observers Japan has an environmental image reminiscent of Dr. Jekyll and Mr. Hyde. Accomplishments in the fields of energy efficiency and antipollution technology vie with less favorable reports of international ecological behavior. Neither image fits perfectly. A look at Japan's internal approach to selected environmental issues -- global warming, waste management and land use -- shows a mixed response by the government, the business sector and the public and helps indicate how Japan's environmental policies are shaped through internal concerns, international attention or -- in some instances -- both.

Introduction

Japan's environmental mien varies in its public and private reflections. To the outside world indifference at times has appeared to color its approach, although this is changing in a great many situations. While ecological concerns are not yet pervasive enough to have generated a master plan for the environment in Japan, episodes involving air and water pollution plus cultural attitudes that encourage a husbanding of resources have helped shape several strict environmental laws. As the world becomes increasingly aware of the shrinking global landscape, almost all countries are paying more attention to the effects of industrialization and the measured responses required to improve standards of living from both an economic and an environmental standpoint. Japan is no exception.

This report will concentrate primarily on domestic environmental policies, not to avoid the controversy of Japan's hand in such international hot spots as deforestation and "strip-mining of the oceans" -- which will be addressed in a later report -- but to offer a broader understanding of selected environmental issues in Japan. In this respect the paper will focus on issues related to global warming, waste management and land use, issues that face every country challenged to accept the responsibility of handling its own industrialization without abusing citizens, neighbors or natural resources.

Global Warming-Related Issues

The current hot topic of global warming generates controversy over whether the expected warming of the earth's atmosphere by a blanket of various gases will be severe enough to pose harmful effects. Most environmentalists push for a quick international response to restrain the devastation of natural buffers like forests and the oceans as well as the growth of "greenhouse" gases, such as carbon dioxide, methane and chlorofluorocarbons. Cautious politicians and industrialists, however, urge more study to determine whether the expected high cost of combating the greenhouse effect is worth the outlay.

Chlorofluorocarbons - Japan generally has joined the majority of other industrialized nations in expressing concern over the greenhouse effect. Most of its concrete actions, however, have dealt with reductions of CFCs, the gas accused of depleting the protective ozone shield in the earth's upper atmosphere. In September 1988 Tokyo signed the Montreal Protocol to freeze CFC production and use at 1986 levels. Since then Japan has supported a CFC ban by the year 2000 provided that substitutes will be available. In meetings with government officials Japanese CFC producers and users learned that as of July 1, 1989 they would face quotas requiring a 30 percent cut to achieve 1986 levels, which were put at 132,200 tons for producers and 9,740 tons for importers (see JEI Report No. 33B, August 25, 1989). The Ministry of International Trade and Industry also offered financial assistance to help develop CFC substitutes and recycling technology.

At least one report has suggested that Japan's willingness to agree to CFC reductions mirrors its recognition that those first to the market with CFC alternatives will have an advantage in the production of less ozone-destructive air conditioners, solvents for cleaning electronics and various types of foam and aerosols. While acknowledging that E.I. duPont de Nemours & Co. has the jump on Japanese firms looking for CFC substitutes, the Economist points out that Japan's top five CFC producers are "pulling out the stops to catch up."[1]

Carbon dioxide - In the more complex arena of CO_2 emissions (see Table 1), Tokyo has taken a more measured approach. The trade-offs being considered to regulate this by-product of industrial activities spur more debate than does the question of how to cope with CFCs. Scientists disagree over whether CO_2 emissions are deleterious and whether the oceans will be able to offset any global warming. Both Tokyo and Washington have urged more study of possible greenhouse effects. They succeeded in dissuading participants at a November

[1] "Friendly Gases," Economist, May 20, 1989, p. 74.

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meeting in the Netherlands from establishing a definitive timetable for reducing CO_2 levels pending a late 1990 report by the United Nations' Intergovernmental Panel on Climate Change. The majority of the 68 nations represented did agree, however, that the output of greenhouse gases should be stabilized as soon as possible (see JEI Report No. 44B, November 17, 1989).

Table 1: Top Four Countries' Emissions of Industrial Carbon Dioxide

(in millions of metric tons of carbon)

	1983		1985		1987	
Country	Amount	Percent of World Total	Amount	Percent of World Total	Amount	Percent of World Total
Japan	239.8	4.7%	254.2	5.0%	251.0	4.4%
United States	1,149.5	22.6	1,201.4	22.3	1,225.6	21.7
USSR	941.4	18.5	987.6	18.4	1040.2	18.4
China	455.2	9.0	538.0	10.0	595.2	10.5

Source: Carbon Dioxide Information Analysis Center (Oakridge, Tennessee: 1989).

On the home front Tokyo is juggling several issues related to global warming. Two are interrelated: fears about waning energy efficiency and possible alternative energy schemes. Also of concern are more severe pollution from a greater number of cars and trucks in use and acid rain, previously thought to be a minor problem in Japan.

Energy efficiency - While many industrialized nations are calling for cuts in CO_2 emissions, not everyone in Tokyo concurs. MITI in particular is cautious about how the reductions would be effected. MITI and others feel that Japan's past record on energy efficiency -- among the best in the industrialized world -- should be weighed so that Japan would not face the same restrictions as energy wastrels. However, since Japan's FY 1988 consumption patterns showed the increase in energy use surpassing the country's economic growth rate (see JEI Report No. 40A, October 20, 1989), many environmental analysts are worried that Japan's economic growth machine will require ever more energy, albeit used under efficiency constraints installed after the twin oil shocks of the 1970s. Also, MITI's 1987 long-range expectation of slightly more than 1 percent growth in energy consumption per year through 1995 was much too optimistic given the past two years' substantially higher usage patterns. Thus, MITI has set about revising its energy consumption forecasts.

Nevertheless, the call for energy efficiency continues to be among Tokyo's preferred measures for alleviating CO_2 emissions. An energy advisory committee to MITI's Agency of Natural Resources and Energy recommended in October a greater reliance on energy efficiency to combat global warming since, it said, all primary energy sources (oil, coal and nuclear) have social or environmental complications.

Possible efficiencies could be found, according to Osayuki Yokoyama of MITI's Agency of Industrial Science and Technology, through industry's utilization of technologies that combine fuel cells and air-conditioning systems, heat pumps to recover otherwise wasted energy or cogeneration.[2] In the home the possibilities for efficiencies include improvements in insulation and electrical appliances. On the road the potential contributions could be made with more fuel-efficient engines and improved traffic and transportation systems.

Alternative energy ideas - Since much of the CO_2 produced is from the breakdown of fossil fuels, a look at fuel alternatives is appropriate. Dirty fuels, such as oil and coal, add more CO_2 to the atmosphere than cleaner fuels like natural gas. Solar and nuclear energy are among the cleanest, and, as such, their proponents have begun waving the global warming banner to attract supporters to their favored power source. The push for nuclear energy is the strongest but is meeting the greatest resistance from those who fear a reenactment of a Chernobyl-style accident.

- Nuclear power - Currently Japan relies on 37 nuclear power plants to generate about 25 percent of its total electricity needs. An ANRE advisory committee recommended in June that nuclear power be considered a serious contender as an alternate to CO_2-producing fossil fuels. But the committee and others have acknowledged that nuclear power meets with mistrust. And, concerned that public antipathy to nuclear power will work against an increase in nuclear capacity, the Science and Technology Agency recently issued a report on nuclear safety that addressed problems and regulations related to nuclear plants.

The paper, released in late October, recommended paying greater attention to the problems of aging reactors and human errors, two areas not likely to reassure a doubting public. Neither is the appearance of two nuclear accident rating schemes likely to instill confidence. Between them the Science and Technology Agency and MITI share jurisdiction over Japan's reactors. Both outlined their rating criteria this past summer, but MITI's system drew the most criticism, perhaps because STA operates more research-oriented facilities. Critics contend that MITI's index could downplay an accident's hazards. In making its criteria public the ministry said that Japan's 390 reactor accidents between 1981 and 1987 would have ranked between 0 and 2 on a scale that would have assigned Chernobyl an 8 and Three Mile Island a 5. Further public relations efforts include disclosure that workers at power plants averaged radiation exposures equivalent to two X-rays in FY 1988. Those most directly exposed averaged 0.18 rems, far below the standard of 5 rems. This report came out the same day MITI approved operations at a new Hokkaido nuclear plant.

- Solar power - Other alternative fuels seen through the greenhouse prism include solar power technologies. MITI, which created the Sunshine and the Moonlight projects for boosting alternative power sources, has committed funds this year to develop solar cells that can be built into a house to improve its energy efficiency. However, manufacturers of solar cells see their greatest sales opportunities overseas, partially because Japanese tax authorities offer no subsidies or deductions for solar systems while the United States does. (The Japanese government, however, provides low-interest loans to buyers of solar water heaters.)

A December Kyodo article noted that the main constraints on small sun-powered generation systems continue to be high manufacturing costs, regulations

[2] Osayuki Yokoyama, "Cooling the Greenhouse," Journal of Japanese Trade and Industry, No. 5, 1989, p. 18.

and an energy industry reluctant to encourage homeowners to set up supplemental power supplies.[3] MITI also has continued to fund projects that convert oil-powered plants to another fuel source (see JEI Report No. 40A, October 20, 1989). In many respects MITI appears to be hoping that scientists will develop technologies that will recover escaped CO_2 and reuse it, thus avoiding major energy conversions.

- Alternative automotive fuels - Perhaps the alternative fuel options closest to entering the market lie in the automotive industry, where both technology and altered traffic patterns are considered keys to reducing greenhouse gases. The number of cars and trucks on the road in Japan has soared in recent years, alarming not only environmentalists but also traffic authorities. In early December they declared a state of emergency after recording the deaths of 10,000 people in traffic accidents between January 1 and November 30 (see Tables 2 and 3).

Table 2: Number of Motor Vehicles in Use in Japan

(in thousands)

Year	Cars	Trucks	Buses	Other	Total	Change
1970	8,779	8,282	188	333	17,582	16.2%
1975	17,236	10,044	226	584	28,091	4.9
1980	23,660	13,178	230	789	37,856	4.5
1985	27,845	17,140	231	942	46,157	3.7
1986	28,654	18,109	233	977	47,972	3.9
1987	29,478	19,163	234	1,027	49,902	4.0
1988	30,776	20,350	238	1,086	52,450	5.1

Source: Ministry of Transportation

Table 3: Passenger Transportation Usage in Tokyo, Nagoya and Osaka

Mode	FY 1970	FY 1975	FY 1980	FY 1983
National Railway	19.5%	20.1%	17.8%	17.7%
Private Railway	24.9	24.0	23.5	23.6
Subway	9.1	10.7	11.1	11.8
Surface Tram	1.9	0.6	0.3	0.2
Bus	17.8	15.9	13.3	12.1
Limousine/Taxi	7.8	5.2	5.2	5.0
Private Car	18.9	23.5	28.8	29.7

Note: The number of passengers carried was placed at 24.7 billion in FY 1970, 26.9 billion in FY 1975, 29.2 billion in FY 1980 and 30.4 billion in FY 1983.

Source: Environment Agency, Quality of the Environment in Japan 1987.

[3] Dennis Pidge, "Solar to Electricity Still Not Cost-Effective in Japan," Kyodo News Service, December 12, 1989.

All those motor vehicles and drivers, however, may be urged in the future to trade in their gas-powered versions for one of a variety of more CO_2-friendly engines. Among the possibilities are electric cars, including solar-cell models, and engines powered either by methanol, natural gas or hydrogen. Other options include two-stroke, lean-burn and variable-displacement engines; the latter two already are powering cars. Analysts are musing whether Japanese automotive makers will be able to repeat their successes of the oil-scarce 1970s with updated versions of fuel-efficient models. And others, for example Ford Motor Co., wonder whether the move to greater fuel efficiency is worth the cost. A November 20 Newsweek article reported that Ford questioned whether a doubling of fuel efficiency, which would halve the amount of CO_2 contributed by cars to the atmosphere (from 1.2 percent of the total to 0.6 percent), is worth the effort.

Of course, fuel efficiency depends not just on the types of fuel used but on the weight of a vehicle, its aerodynamics and its engine operation, among other variables. The Japanese are exploring all these areas. The Environment Agency has set up a panel to look into methanol-powered engines, while MITI's Japan Automobile Research Center is testing 12 varieties of such vehicles developed in conjunction with eight of Japan's automakers.[4] Running in the same popularity league as methanol is the electric car. Several versions have surfaced in Japan and not only at car shows. MITI has recorded the use of 700 on-road vehicles and 1,380 off-road cars powered by electricity, usually for deliveries or resort use. The major push here is for sustained service with highway-capable speeds.

While not as popular a draw for research in Japan, natural gas-powered engines currently are in use in many areas (including British Columbia). Osaka Gas Co., Ltd. began test runs in September on a Mitsubishi Motors Corp. car that had been outfitted with a natural gas combustion chamber. Initial reports indicate the engine generates 30 percent less CO_2 than regular engines. Perhaps the also-ran in current research is the hydrogen-powered car, which continues to be tested to improve its performance.

As for two-stroke engines, Japanese motor vehicle manufacturers will be competing with Australian Orbital Engine Co. and U.S. firms to achieve the right blend of fuel efficiency and power. The other two innovations, lean-burn and variable-displacement, already are installed in some Japanese cars and achieving up to 20 percent greater fuel efficiencies. Aerodynamic engineering continues to challenge all producers, with recent Japanese luxury models relying partly on styling to help keep within the limits set for American fuel efficiency.

What implementation of some of these developments can mean for global warming is less CO_2 -- except for the fact that more cars and trucks are on the roads. Similarly, customers and manufacturers alike are having fun with more powerful, less fuel-efficient models that are taking advantage of low gasoline costs in most countries. Alan Miller, director of the Center for Global Change, wrote in September that Japan's growth in personal income and the declining real price of oil have helped boost that country's demand for larger cars. "The government has not attempted to combat this trend with higher gasoline taxes and in 1988 removed a tax penalty on larger cars as part of recent tax

[4] "Interest in Alternate Fuel Revs Up," Focus Japan, October 1989, p. 5.

'reform' legislation," Miller wrote.[5] Nevertheless, the average cost of gasoline in Japan still surpasses the equivalent figure for the United States.

One response to the greater amount of traffic comes from the Transportation Ministry, which is seeking funds in the FY 1990 budget for a two-year research project to determine the extent of CO_2 emissions from air, land and sea vehicles. A by-product of the research is expected to be a renewed emphasis on public transportation as well as development of traffic patterns designed to speed buses along crowded highways. The Environment Agency's 1989 white paper urged improved traffic control as well as economic incentives for low-pollution vehicles as part of its promotion of an "Ecopolis," a city where people live in harmony with the environment (the theme of last year's white paper on the environment).

Nitrogen oxides - Another automotive-related concern associated with global warming is pollution from nitrogen oxides, which contribute to smog and, thus, to greenhouse warming. Technology, such as the catalytic converter, has gone a long way in reducing NO_x emissions, but they remain a problem in Japan. Based on a yearly average of 22 car exhaust monitoring stations, emissions of nitrogen dioxide rose in FY 1987 to 0.041 parts per million, the highest level in four years. All the recent readings at these stations have been above the estimated annual standard of between 0.02 and 0.03 ppm. The high of 0.042 ppm was recorded in FY 1978, the year the government enacted a requirement to reduce NO_x emissions from cars by 92 percent. (At more generalized environmental and air pollution monitoring stations the emissions fall within the standards, averaging 0.025 between FY 1982 and FY 1986 at 15 sites but increasing in FY 1987 to 0.028, still within the limits.)

NO_x emission standards are strict. A publication by the Ministry of Foreign Affairs notes that Japan's 1977 NO_x emission standards, which required cutting the earlier level by one-tenth, were so stringent that both foreign and domestic carmakers received a grace period for compliance.[6] In a comparison with other industrialized countries, however, Japan ranked lowest in NO_x emissions with 1.6 million tons, 2.3 percent of world totals in 1983; the top-listed polluter, the United States, emitted 21.3 million tons, 31 percent of the world total. Italy ranked second lowest with 1.7 million tons.

The problem is that NO_x and NO_2 emissions have not decreased much since the 1970s, despite the strict laws. Cities are particularly upset that NO_x density in certain areas has exceeded standards for two years. At a June meeting in Tokyo six local governments sought tighter auto emission standards for NO_x. New limits continue to be put into effect for emissions from various weights of trucks and buses on a schedule that began in December 1988 with diesel and gasoline-powered vehicles of under 1.7 tons and will continue through April 1, 1992 to include midget imports. In its 1989 white paper the Environment Agency urged curbs on vehicular traffic, particularly in urban areas, to counter the high NO_x levels. Increased truck use to move goods was one of the causes of continued high NO_x levels, the white paper said. Whether

[5] Alan Miller, "Perspectives on Global Warming in Japan" (unpublished paper, September 1989), p. 9.

[6] Ministry of Foreign Affairs, Japan's Approach to Environmental Issues of the Globe (Tokyo: September 1989).

the attention paid to various types of clean-energy fuel will affect, or possibly worsen (in the case of natural gas), NO_x emissions remains to be seen.

As in the case of NO_x emissions, the interplay between pollutants and global warming is complex. Nitrogen and methane may even neutralize the harmful effects of ozone-depleting gases in the upper atmosphere. But the interaction of NO_x with other gases in the breathable air can add to harmful smog, and, as NO_2, the pollutant contributes to acid rain.

Sulfur dioxide - Another factor in acid rain is sulfur dioxide. Japan's emission standards for both NO_2 and SO_2 are among the lowest, if not the lowest, in the world (see Table 4). Perhaps because industrial emissions are more easily controlled than emissions from an increasing number of vehicles (the main cause of NO_x output), Japan's SO_2 levels have dropped from a high of 0.059 ppm in FY 1967 to the FY 1987 low of 0.010, as recorded at 15 general environmental and air pollution monitoring sites. A cross-country comparison shows Japan with a low 1.1 percent of world sulfur oxide emissions at 1.19 million tons; the United States contributed 21.4 percent, or 23.38 million tons of SO_x. Japan's SO_2 standard is about one-third that of the U.S. daily limit.

Table 4: Comparison of Sulfur Dioxide and Nitrogen Oxide Emissions

(in thousands of metric tons)

	Japan		United States	
Pollutant	1980	1983	1980	1985
Sulfur Dioxide	1,259	1,079	23,200	20,700
Standards (parts per million)*	0.04		0.14	
Nitrogen Oxides**	1,339	1,416	20,300	20,000
Standards (parts per million) for Nitrogen Dioxide (NO_2)***	0.02-0.03		0.05	

*Standards calculated on a per-day basis.

**Nitrogen dioxide is measured in the atmosphere. Nitrogen oxides refer to both nitric oxide (NO) and NO_2.

***Figures estimated by converting Japan's per-day numbers to per-year numbers equivalent to the U.S. calculations.

Sources: Ministry of Foreign Affairs, Japan's Approach to Environmental Issues of the Globe, and World Resources Institute/International Institute for Environment and Development, World Resources 1988-89.

Japan's experience with reducing SO_2 emissions illustrates how Tokyo administers some of its antipollution laws. At the central government level standards are set and officials use administrative guidance on a case-by-case basis to help areas stay within pollution limits. Encouraged in the use of smokestack gas desulfurization and denitration technologies, industries also may find their renovation or expansion plans subject to recommendations, for example on the types of fuel to be used. A 1977 report by the Organization for

Economic Cooperation and Development noted: "In the plant-by-plant agreements signed between local governments and plant managements, the sulfur content of fuels is often prescribed."[7] The report also said, "The Japanese approach to pollution abatement therefore relies basically on 'administrative guidance' -- in the spirit of a planned economy rather than in the spirit of a market economy." In support of its view that official guidance engenders more compliance than the threat of punishment, the report described how on-site monitoring devices could detect changes in emissions so quickly that officials could place phone calls to potential violators urging them to switch fuels or adjust their processes.[8]

However, policing powers exist both through the threat of a tax to be imposed under the Compensation Law Scheme (which is applied to SO_2 violators) as well as judgment under the polluter-pays principle, which allows victims of pollution to take alleged perpetrators to court to obtain recompense. The most famous uses of this compensation device are related to water pollution cases like Minamata, when mercury linked to the Chisso Corp. was blamed for illness and the deaths of 1,030 people by yearend 1987. The case is credited with being the alarm that woke Japan to the dangers of unaudited industrialization.

Acid rain - Despite its successes with SO_2 reduction, however, Japan faces a growing problem with acid rain. The Foreign Ministry's September 1989 pamphlet on environmental issues indicates a degree of initial unconcern about the problem: "Emissions of SO_x and NO_x in Japan, strictly regulated and implemented, are considerably less when compared with the emissions in Europe and North America. Nevertheless, in order to prevent possible damage in the future, Japan promotes the research and study of acid rain as well as air pollution monitoring." However, late this past summer the Environment Agency reported its findings from a four-year sampling of more than 150 areas. The study revealed that all monitoring points had pH values under 5.6; numbers under 5.6 indicate acidity. The lowest had a pH value of 4.4, which was recorded in the Musashino community near Tokyo.

Earlier reports suggest that many Japanese believe their own emission controls are effective but that much of the pollution drifts from factories in China and South Korea. For example, a Japan Times report from December 1988 attributed high sulfuric and nitric acid readings taken in Nagasaki prefecture to pollutants from the mainland since "the pollution detected was different from typical air pollution over Japan . . . (and) increased after a north wind blew from the continent."[9] In an obvious link between its technological prowess and antipollution advances, Tokyo is seeing how aid to other countries to combat pollution can help improve its own air quality.

Technology key - Japan's approach to the global warming issue -- in addition to its support for further research -- relies primarily on technological

[7] Organization for Economic Cooperation and Development, Environmental Policies in Japan (Paris: 1977), p. 35.

[8] Ibid., pp.22-23.

[9] "Gases released on Asian mainland found to worsen pollution in Japan," Japan Times, December 30, 1988, p. 2.

innovations. Nowhere was that clearer than in recommendations made to the U.N. Intergovernmental Panel on Climate Change. Although the Environment Agency initially had proposed that the report should contain an index limiting each country to a certain amount of carbon dioxide output, this initiative was not included in the recommendations submitted in September. Neither was another variation of the quota system, the International Emission Trade Market in which those capable of reducing CO_2 output beneath a designated quota could sell credits to polluters, which would have a monetary incentive to reduce their own pollution. However, the consensus reached for Japan's report to the IPCC centered on using alternative energy sources, developing technologies that limit CO_2 output and drafting strategies to cope with the effects of global warming.

Eager to be among the leaders in addressing problems of climate change, Japan's strongest assets may be the model it provides for energy-efficient economic development and the technological innovations that could be trend-setters in an era of high pollution concerns. Since pollution problems impact even this technologically advanced country, however, the model will continue to be only a model student and not a master professor.

Waste Management

Japan sailed into the 1980s with a reputation built on its heritage of wasting few resources because it had few of its own. In the past decade, however, affluence not only has increased the amount of packaging, paper and waste but bred an indifference to recycling since "new" costs only slightly more (or possibly even less) than "recycled." Compounding the problems of waste and recycling are global-warming issues, such as: if nuclear power plants substitute for fossil fuel-burning plants, then how will the spent fuel be stored? Japan's industrial strength also is generating industrial-strength garbage, which will sorely test its strong record of waste treatment.

When it comes to handling its own solid waste Japan has yet to engage the garbage transports made famous by New York state, Canada and Italy. Health and Welfare Ministry officials reportedly have said Japan exports "almost no" toxic wastes, but they expect that day to arrive soon since domestic disposal options are approaching full capacity. In that expectation ministry officials have said Japan is willing to work with the U.N. Environment Program on international regulations for waste transport, even though Tokyo has not yet signed the U.N.-sponsored Basel convention on hazardous waste exports. That document is somewhat controversial in that environmentalists contend it facilitates dumping in Third World countries while others say the convention is needed to regulate the types of wastes and assign responsibilities for ultimate disposal.

Although Japan generally receives international kudos for its solid waste management programs, not all analysts are convinced of the programs' safety measures. Incinerators handle the majority of nonrecycled materials, and landfills -- including islands of waste repositories -- are responsible for the rest. Much of the processed waste is recycled, with industries responsible for handling their own wastes.[10] One Health and Welfare Ministry report last year noted that about 41 percent of all industrial wastes were recycled; 29 percent became part of reclamation projects, and the remainder was incinerated. A Council of State Governments study mission to Japan, however, indicated both amazement and concern over some of the waste handling. The visitors were surprised to see the care taken at one factory to separate from the waste flow each heavy metal in "different process lines . . . a costly option not frequently used in the U.S." They also noted the attention to detail in "a sludge incinerator being used at a sewage treatment plant, in an effort to reduce the volume of landfill waste." But the mission was puzzled over a lack of evident concern about incinerator emissions, such as dioxin (a carcinogen). "The plants we visited," the report said, "did not monitor these chemicals from their stacks . . . we drew the conclusion that concern about these chemicals is low in Japan." That assessment was reinforced, they said, after a newspaper reported that a recent university study "had shown the level of dioxin ingestion in Japan was 63 picograms/person/day, against a U.S. standard of 50. The standard in Japan is 5,000 picograms/day. The sources of this chemical were not given."[11]

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[10] Council of State Governments, Environmental Management in Japan: What Can the States Learn? (Lexington, Kentucky: n.d.).

As indicated by the COSG report, definitions and reporting methods about waste output, including hazardous materials, may make comparisons imprecise. Table 5, which shows Japan's hazardous waste production to be less than 1 percent of the U.S. output, should be viewed in that context. Another hazardous waste listing, however, may be considered more concrete, given the international attention paid to nuclear power plants and spent fuel. Table 6 shows Japan's spent nuclear plant waste as being about 4,300 metric tons. Storage currently is all aboveground, but a long-range plan proposes storage at Japan's largest nuclear fuel recycling complex, located in northern Honshu. The project, however, recently underwent radical revision. One report suggested that the alterations, which address concerns about rain or underground water leaking into the storage areas, may delay operation of the facility for another two years. The first outline for the Rokkasho, Aomori prefecture complex met strong public

Table 5: Waste Generation in Japan and the United States, 1983

(totals in thousands of metric tons)

Country	Municipal Waste Output			Industrial Waste Generation			Hazardous/ Special Waste	
	Total	Per Capita (lbs.)	Per Area*	Total	Per GDP*	Per Area*	Total	Per Area*
Japan	45,328	752	110.8	243,264	545	594.5	847	2.1
United States**	196,334	1,637	19.4	676,139	553	66.9	275,750	27.3

*Per GDP: per unit of gross domestic product; per area: metric tons per square kilometer per year.

**Figures on U.S. industrial waste generation are for 1985.

Source: World Resources Institute/International Institute for Environment and Development, World Resources 1988-89.

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[11] Ibid., p. 7.

opposition; the revised version is expected to create skepticism over previous assurances of safety. Once completed the facility is expected to enable storage over the next 300 years.

Table 6: Japan's Nuclear Power Production and Waste Generation, 1986

	Number of Reactors	Net Capacity (megawatts)	Spent Fuel Inventory (cumulative metric tons of heavy metals)
Operating	34	24,754	4,300
Planned or under Construction	30	28,871	---

Source: World Resources Institute/International Institute for Environment and Development, World Resources 1988-89.

Public concern over incinerators and nuclear storage is as prevalent in Japan as elsewhere. The COSG report noted, however, that despite opposition incinerators often are built adjacent to residential areas and even used to heat senior citizens' complexes. Opposition in Sapporo over one plant lessened when residents learned that the affiliated heat-generating facility would reduce their heating costs. Another recent controversy over an incinerator focused less on its presence and more on the local government's handling of its relocation. Consensus is especially important in Japan's decisionmaking processes and may be one key to Japan's successful waste-handling programs.

Whether that success will continue in Japan's affluent society is unclear. The strength of the yen helps make raw materials cheaper in some cases than recycled material. And citizens who feel wealthy are less inclined to spend the time cleaning cans and bottles for recycling, reports have suggested.

Officials worried about Japan's increasing waste volume and affluent ways are calling for more recycling and care for disposal. The prime target is used paper, which has multiplied under the influence of fax machines, computers and copiers (see Table 7). As a result, the government has set up a Paper Recycling Promotion Center headquartered in Tokyo, where the local government already requires household separation of wastes. The aim of the new group, according to MITI, is to encourage major firms to recycle office waste paper. Another recycling cheerleader is the Clean Japan Center, which offers prizes for innovation in waste management as well as information. The MITI affiliate also is proposing large-scale waste processing centers that would double as heat generators. Yet another agency lending new attention to waste management is the Health and Welfare Ministry, which in November released a draft of guidelines for disposal of wastes related to hepatitis and human immunodeficiency hazards. The ministry estimates that medical wastes make up roughly 132,000 tons of the estimated 847,000 tons generated each year in Japan.

Recycling and waste management coincide naturally with Japan's oft-repeated concern about being a small nation with few natural resources. In an

Table 7: Comparison of Municipal Waste in Japan and the United States

Country	Year	Total (in 1000 metric tons)	Per Capita (in kg)	Percent Distribution			
				Paper Products	Plastics	Glass	Other
Japan							
	1980	41,511	355	27.4%	12.3%	8.0%*	52.3%
	1985	41,530	344	38.3	7.7	1.3	52.7
United States							
	1980	160,000	703	29.7	5.3	10.3	54.7
	1983**	178,000	744	34.7	6.7	9.0	49.6

*Includes ceramics.

**U.S. figures for total municipal waste were estimated by OECD for 1983. The percentages for paper products, plastics, glass and other waste are 1984 figures instead of 1983 data.

Source: Organization for Economic Cooperation and Development, Environmental Data Compendium 1989.

odd twist these issues fit into the third category to be briefly discussed here: land use.

Land Use

American trade negotiators see the term "land use" in Japan and immediately begin suggesting ways that urban farmland can be turned into housing complexes. But land use to the environmentally concerned could mean increased parkland for an improved aesthetic (see JEI Report No. 30A, August 4, 1989 for a look at housing and land use). Other land use options could entail expansion of land mass for waste disposal or even subterranean excavation.

In ecological terms the Tokyo area would not necessarily benefit if its 82,000 acres of farmland became residential fodder. Urbanization is putting greater strain on facilities that treat water, sewage and waste. If more people could buy housing sites closer to their jobs they possibly could take more public transportation and ease the strain on road use, but given greater housing availability the population density might be more likely to increase instead. While Tokyo continues to be bombarded with alternative uses for urban farmland and to struggle with the consequences of high land prices, those concerned with global warming see nothing wrong with more parkland and green space, which, if planted with CO_2-consuming shrubs and trees, would be more beneficial to the atmosphere than methane-producing rice paddies. The 1989 white paper on the environment suggested conservation of existing natural habitats in urban areas and creation of others, such as wildlife sanctuaries, gardening plots and "green trusts."

With limited space for expansion Japan has turned to the sea and begun building islands out of waste, thus solving two problems and perhaps creating new ones. Noncombustible waste, for example, goes from Tokyo collection centers to a reclaimed island in Tokyo Bay. In the Osaka Bay Phoenix Plan about 150 local governments in six Kansai-area prefectures are cooperating to create islands off Amagasaki Port and Izumiotsu Port. Most of the deposits will be incinerated first, and only waste under specified toxicity limits will be permitted. Nevertheless, some nearby residents question the extent of protection offered by the barriers built to contain the waste. Although not addressed in this report, water pollution poses possibly one of Japan's biggest ongoing environmental problems.

Another innovative project with potential ecological disruption is the Neo-Urban Industrial Geo-dome, a seven-year MITI-sponsored proposal to study use of underground space for energy facilities, for example. Among other proposals for use of land deep within the earth are subways, highways, reservoirs and sewage disposal plants. Although engineers say they can offset the hazards from earthquakes, an environmental impact assessment would seem to be reasonable. The question of who would be responsible for such an assessment, however, exposes Japan's fragmented environmental policymaking process.

Public and Industry Attitudes

As can be discerned from the topics addressed in this report, several agencies deal with environmental matters and not all approach them from the same perspective. MITI tends toward industry's viewpoint, while the less powerful Environment Agency places ecological concerns uppermost. The Ministry of Agriculture, Forestry and Fisheries addresses some environmental issues, while the Ministry of Foreign Affairs helps coordinate the response to international problems. Mr. Miller of the Center for Global Change suggests that Japan's ability to respond to environmental issues is impeded by this divergence of responsibilities as well as by the "absence of an organized constituency backing the recommendations made in the reports."[12] Another impediment to a "green" movement in Japan, according to some sources, is the past perception of the ecologist in Japan as a rabble-rouser, an image not sought by a people with the adage that the nail that sticks out is the one hammered down.

Nevertheless, the worldwide attention being paid to the environment, particularly to global warming and its effect on industry, has impacted Japan, too. Environmental enthusiasm in Japan is a subject of some disagreement. A United Nations/Lou Harris poll showed far more Japanese rate their environment negatively than do Americans (see Table 8). Yet more are unwilling to pay higher taxes to prevent pollution (38 percent versus 18 percent of the Americans surveyed). However, in a Yomiuri Shimbun/Gallup Poll Japanese respondents outnumbered Americans in supporting environmental protection over economic development. Yet another survey suggested that Japanese consumers will buy environmentally hazardous products because they feel they have no choice or because they do not care about the potential impact. Only 14 percent of those surveyed said they avoided buying ecologically questionable goods -- such as those containing CFCs. The early 1989 survey by the Prime Minister's Office showed that the top environmental concern among those surveyed was industrial pollution (44 percent), followed by household noise and water pollution (38 percent), toxic waste pollution (31 percent) and nuclear power safety (30 percent). Such global worries as depletion of the ozone layer drew a top rating from only 21 percent.

[12] Alan Miller, "Three Reports on Japan and the Global Environment," Environment, XXXI, No. 6, July-August 1989, p. 28.

Table 8: Public Attitudes Toward Environment

Questions	Japan	United States	West Germany
*Economic development must have priority	4%	7%	1%
*Economic development should have priority	18	39	31
*Environmental protection must receive priority	13	12	20
*Environmental protection should receive priority	58	39	41
**Rating of country's environment			
Positive	16	35	15
Negative	83	64	83
**Should this country do more or less to protect environment/ curb pollution?			
More	91	97	83
Less	1	1	3
About the same	7	1	11
Not sure	1	--	3
**Degree of willingness to pay higher taxes for pollution prevention and similar measures			
Very willing	9	29	20
Somewhat willing	53	52	42
Not very willing	31	8	19
Not at all willing	7	10	12
Not sure	--	1	7

*Yomiuri Shimbun/Gallup Poll 1989
**UN Environment Program/Lou Harris Poll 1989

To deal with the individual consumer's concerns about the environment the Japan Environment Association introduced in February 1989 an Ecomark system similar to one being used in West Germany. Manufacturers (both domestic and foreign) that want their products to bear an Ecomark apply to the Japan Environment Association and must be able to attest that use of their product involves minimal or no pollution and/or could improve the environment. Also important is that disposal will cause minimal if any problems and that energy or resources be conserved through the product's use. Payment of a fee that ranges from Y80,000 to Y200,000 ($571 to $1,429 at Y140=$1.00) and signing of a two-year licensing contract rounds out the process. By August last year approximately 151 products had been approved. In a report about the project the external arm of the Environment Agency indicated that it hoped manufacturers and distributors would respond to consumer demand for certified products.

More organized than consumers is industry's response to concerns about global warming and other environmental issues. Keidanren (Japan Federation of Economic Organizations) issued a report in October emphasizing that the high cost of addressing CO_2 proliferation should be weighed against the potential damage to economic growth. The report urged technological advances to offset possible climatic change and sharing Japan's technological expertise with developing countries. Both the Japan Automobile Manufacturers Association and the Japan Chemical Industry Association are researching environmental impacts on their respective industries in efforts to minimize any attempt by Tokyo to impose strict antipollution or related regulations. However, these industries are perhaps in the vanguard of those able to capitalize on the market opportunities of advanced technologies.

Conclusion

Although not inspired by a grass-roots "green" movement such as that in Europe, Japanese policymakers find their ecological motivation from both a realization of potential environmental hazards within Japan and international pressures. Neither are they ignorant of the opportunities for world leadership and industrial advances to be made by adopting environmentally sensitive policies that advance economic well-being. Both the 1988 and the 1989 white papers on the environment addressed Japan's international role. While Tokyo can herald the Japanese model for some environmental issues like energy efficiency and emissions of nitrogen and sulfur oxides, other issues remain unexplored. The increased attention being paid to the overall environment is likely to make officials more aware of domestic pollution problems as well as the relationship between global and internal problems and the market opportunities presented to technological innovators.

For further information, contact Pat Murdo.

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The view expressed in this report are those of the author and do not necessarily represent those of the Japan Economic Institute.

APPENDIX

Government and Private Outlays on Environmental Protection Measures in Japan

(in billions of dollars and millions of yen)

	Government				Private Sector*		
	Total		Change				
Fiscal Year	dollars	yen	dollars	yen	Antipollution Investments	Change	Percent of Total Outlays
1987	$7.52	Y1,087,867	15.8%	-1.0%	$1.60	--	3.6%
1988	10.02	1,284,769	33.2	18.1	2.11	25.7%	3.5
1989**	9.24	--	-7.7	--	1.92	-8.7	3.5

Note: Due to exchange rate changes, the dollar-based figures show a decrease in FY 1989, although the yen-denominated amounts increased. For government expenditures that rise was 3.5 percent; for the private sector the boost was 2.4 percent.

*Not figured in yen. Overall industry expenditures for pollution control averaged Y893.4 billion for the combined years of 1985 through 1987.
**Proposed outlays.

Source: Ministry of Foreign Affairs and Ministry of International Trade and Industry

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REPORT

A Two-Part Report: A and B

NO. 1B
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IN THIS ISSUE:

Government Optimistic About FY 1990 1

BOJ Ushers In 1990 With Higher Discount Rate And New Leader 3

FY 1989 Supplemental Budget Approved 4

Cabinet Sets FY 1990 Spending Plan 6

Japan's Proposed Defense Budget Up 6.1 Percent 11

FY 1990 Foreign Aid Budget Increase Tops 8 Percent 13

Notes: Import Promotion; Textile Pact 14

Government Optimistic About FY 1990

When Tokyo released its economic outlook for fiscal year 1990 on December 22, 1989, some observers may have experienced deju vu, feeling that they had heard not only the government's argument but the differing private-sector perspective about a year earlier. In January 1989 Tokyo had said that it expected economic growth in the 12 months through March 1990 to slow modestly from the April 1, 1988-March 31, 1989 period but to be cushioned by a healthy rise in consumer spending. Private forecasters at that time saw things differently, expecting greater strength than did the government from plant and equipment spending and less from consumer spending, with overall real economic growth ending up a couple tenths of a percentage point above 4 percent.

Substitute "next year" for "this year" and one gets FY 1990's economic outlook. The government prediction of 4 percent real growth in FY 1990 is

Japan Economic Institute 1000 Connecticut Avenue, N.W., Washington, D.C. 20036 202·296·5633

exactly what it expected a year ago for the fiscal year now ending. All 13 banks and research institutes surveyed in December by the *Japan Economic Journal* think the government estimate of 7.3 percent real growth in capital spending is too pessimistic. Their forecasts of plant and equipment spending range from 7.4 percent to 10.5 percent. Seven of the 13 private forecasters are less optimistic than Tokyo about consumer spending. On balance, 11 of the 13 believe the overall growth rate will be higher than the 4 percent expected by the government, with estimates going as high as 5 percent.

As the Table shows, the private forecasts of a year ago are likely to be closer to the mark for FY 1989 than last January's official outlook. If the private forecasters erred, it was in being too close to the government figures; Tokyo now concedes that real economic growth for FY 1989 will be about 4.6 percent, led by plant and equipment spending, up a whopping 14.5 percent rather than the 9.2 percent expected a year ago. Conversely, consumer spending will grow only 3.2 percent rather than the 4.6 percent expected earlier.

Government's FY 1990 Economic Outlook

(percent change except where noted)

	Actual			Estimated	Projected
	FY 1986	FY 1987	FY 1988	FY 1989	FY 1990
Real Gross National Product	2.7%	5.4%	5.3%	4.6%	4.0%
Consumer Spending	3.4	4.5	5.0	3.2	4.6
Residential Construction	11.0	25.7	5.3	0.2	0.3
Private Capital Spending	4.3	10.1	17.3	14.5	7.3
Wholesale Prices	-9.4	-2.0	-0.7	3.5	0.6
Consumer Prices	0.0	0.5	0.8	2.7	1.6
Unemployment Rate (percent)	2.8	2.8	2.4	2.3	2.3
Yen-Dollar Exchange Rate	Y159.8	Y138.3	Y128.3	Y141.3	Y142.5
Current Account Surplus (billions of dollars)	$94.1	$84.5	$77.3	$61.0	$56.0
Trade Surplus (billions of dollars)	101.6	94.0	95.3	81.0	78.0

Source: Economic Planning Agency

Will business forecasters prove correct again? In past years the private consensus forecast has proved more accurate than the government outlook only about half the time. Certainly, Tokyo could argue that economic forecasting resembles weather forecasting: getting the timing right can be tricky. The government may have been wrong about the pace of the slowdown in economic growth but right about its eventual occurrence, much as a weather pattern often takes longer than expected to arrive.

Government and private forecasters agreed on many aspects of the economy's performance a year ago and generally are in harmony again this year. The current account balance and the trade surplus in dollar terms have declined substantially. The drops, in fact, have been much larger than either side anticipated, due to booming domestic demand and the yen-dollar exchange rate being more favorable to the dollar than the one initially penciled in, thus leading to a J-curve effect. Both the private forecasts and the government outlook assume a considerable slowing of progress on the trade front in the coming fiscal year. However, despite these developments, Tokyo expects the external sector to cut economic growth in FY 1989 by 0.7 percentage point, exactly as it expected a year ago, and to shave another 0.5 point off the expansion rate in FY 1990. If these figures prove accurate, by the end of March 1991 Japan will have seen net exports shrink for five straight years.

On balance, the consensus of private and public forecasters is for more of the same on nearly all economic fronts. Given Japan's outstanding economic performance in recent years, that outlook has to be encouraging to Japanese politicians facing an election. Washington, of course, has its concerns over the numbers, especially current and prospective plant and equipment spending, which it fears could lead to higher exports, but generally the macroeconomic performance of Japan has been one of the bright spots in the bilateral relationship. In early 1987 the United States wanted Japan to get its economy rolling; virtually no one in Washington can deny that Japan has done just that.

Douglas Ostrom

BOJ Ushers In 1990 With Higher Discount Rate And New Leader

As 1989 dawned the Bank of Japan's discount rate seemed just short of being etched in stone: it had been kept at the same 2.5 percent level since February 1987. The rate is the charge BOJ assesses its bank borrowers and directly influences a wide variety of interest rates on savings, home loans and corporate borrowing. Against that background few could have been prepared for what 1989 would bring. The bank raised the rate three times in 1989, the last instance being a half percentage point hike on Christmas Day. At yearend the rate stood at 4.25 percent, a level it last reached in early 1986.

In reaching its decision BOJ and its new governor, Yasushi Mieno, who had taken office only nine days earlier, were influenced by the same set of factors that had been decisive concerning the earlier hikes. Economic forces were all pointing to the same decision October 11, for example, when BOJ had raised the rate half a point (see JEI Report No. 40B, October 20, 1989). During 1989 rising consumer and business demand had led to labor and product shortages and produced inflationary pressures, although prices still are only edging upward. By its modest contribution BOJ hopes to help cool domestic demand by making borrowing more expensive. In addition, the rise in rates is expected to make Japanese investors more likely to keep their money at home, thereby reducing the demand for dollars and other foreign currencies and propping up the yen in international money markets. Through much of 1989 the yen appeared to be in need of such support as it continuously lost ground against the dollar and several other major currencies.

In deciding to raise the rate a third time in December BOJ apparently felt that the earlier boosts had not been enough. The yen had varied little against the dollar between October and December, for example, despite the earlier increases. In Europe, Japan and the United States worries were mounting that the sustained weakness of the yen could lead to an upturn in Japan's already large trade surplus.

BOJ's repetitive hikes in the discount rate can be regarded as a preemptive strike against such a possibility. As such, they mesh neatly with Washington's strategy, which has leaned toward a looser monetary policy -- and lower interest rates -- in an effort to prevent a sharp U.S. economic downturn. An extra bonus of the U.S. policy has been a downward push on the dollar, although that effect so far has been minimal against the yen. In short, Japanese and American policies, through opposite domestic economic actions, both are trying to push the yen higher against the dollar.

While Washington policymakers presumably applauded the latest BOJ move, decisionmakers in Tokyo, at least initially, were less enthusiastic. In response to mid-December statements by BOJ officials that led many experts to conclude a hike was imminent, Minister of Finance Ryutaro Hashimoto hastened to dampen such speculation. Although in this instance the discount rate increase eventually was implemented, Mr. Hashimoto's word carried considerable weight since MOF and BOJ cooperate closely and BOJ seldom acts independently. In fact, MOF and BOJ alternate in providing governors for BOJ. The latest public disagreement coincided with BOJ's retiring leader, Satoshi Sumita, an MOF career official, handing over the post to Mr. Mieno, who has worked his way up through BOJ.

BOJ governors serve five-year terms, making them relatively permanent fixtures in Japanese economic policy. Mr. Sumita's tenure spanned that of four Japanese prime ministers, albeit with three of those in the last year. With the Diet's upper house likely to be in opposition hands throughout his term in office, the political environment in which Mr. Mieno will have to operate could be particularly difficult. How well BOJ's technical skills mesh with political imperatives will get an early test in the first part of 1990, when lower house elections are all but certain. BOJ's concerns -- with the potential, rather than the reality, of dangerous inflation and with the possibility of a growing trade imbalance, which recently has been subsiding -- suggest a longer-term perspective than that of politicians, who half a year from now could be out of office.

While the Japanese economy remains extraordinarily healthy, the higher interest rates BOJ policies already have brought in their wake are surely anathema to politicians who have to face voters concerned with higher mortgage and other consumer lending rates, for example. Whatever the favorable consequences of higher interest rates for the nation's long-run economic health, politicians may not necessarily equate these policies with their own political well-being.

Douglas Ostrom

FY 1989 Supplemental Budget Approved

On December 29 the cabinet of Prime Minister Toshiki Kaifu approved a Ministry of Finance proposal to add nearly Y5.9 trillion ($42.1 billion at Y140=$1.00) to the central government's spending plan for fiscal 1989 (ending March 31, 1990). The supplemental budget allows Tokyo to meet unpredictable

FY 1989 Initial, Supplemental and Revised General Account Budget

(in billions of yen)

Initial FY 1989 (affected categories only)		Supplemental FY 1989		Revised FY 1989
Revenues				
Taxes	Y51,010.0	Taxes	Y3,217.0	Y54,227.0
Nontax Revenues	2,293.2	Nontax Revenues	344.4	2,637.6
Bonds	7,111.0	Bonds	0.0	7,111.0
Construction	5,780.0	Construction	650.0	6,430.0
Deficit Financing	1,331.0	Deficit Financing	-650.0	681.0
		Carryover from FY 1988	2,336.3	2,336.3
		Expenditures	1,732.1	
		Transfers to Local Governments	604.2	
Total	60,414.2	Total	5,897.7	66,311.9
Expenditures				
Transfers to Local Governments	13,368.8	Transfers to Local Governments	1,595.9	14,964.7
		FY 1988 Surplus	604.2	
		FY 1989 Natural Increase	991.7	
Social Welfare	10,894.7	Social Welfare	1,560.0	12,454.7
		Public Welfare Insurance	1,500.0	
Public Works	6,130.7	Public Works	1,304.6	7,435.3
Disaster Relief	66.7	Disaster Relief	425.6	492.3
Housing Development	764.4	Housing and Urban Development	775.7	1,540.1
Social Capital	1,300.0	Social Capital	267.7	1,567.7
Food Control Programs	418.2	Agricultural Programs	50.0	468.2
Small Business Measures	194.2	Business Measures	171.4	365.6
Miscellaneous Outlays	4,058.1	Miscellaneous Outlays	81.9	4,140.0
		Wage Increases	54.6	
		Japanese Railways Debt Liquidation	450.0	
		Miscellaneous Reductions	-760.5	
		Other	337.8	
		National Debt Redemption	866.1	866.1
Total Expenditures	60,414.2	Total Supplement	5,897.7	66,311.9

needs, such as disaster relief, and to handle any surplus or deficit from the previous fiscal year. For the second year in a row, however, Tokyo also has used the supplemental budget to expand foreign-oriented programs.

Revised revenue estimates for FY 1989 show that Tokyo continues to suffer from an embarrassment of riches (see Table). Tax revenues are projected to be more than 6 percent above the initial estimate thanks to strong economic activity. The surplus carried over from the previous fiscal year also will be significant (Y2.3 trillion or $16.7 billion), though less than the FY 1987 carryover (just under Y3 trillion or $21.3 billion). The extra income allows MOF to cut the issue of deficit financing bonds in half, in line with the government's pledge to eliminate new issues of such bonds by FY 1990. The effect on the total amount of debt issued, however, will be zero since an equivalent amount of construction bonds has been added.

On the expenditure side the FY 1989 supplement contains many of the usual items: the majority of disaster relief funds; a strong increase in other public works spending; a Y50 billion ($357.1 million) boost in spending for small business programs and a special allotment of Y121.4 billion ($867.1 million) for the silk industry; a wage hike for civil servants (Y54.6 billion or $390 million); and miscellaneous administrative costs and cost savings. There are some new items as well: Y450 billion ($3.2 billion) to pay off some of the ex-Japanese National Railways' huge long-term debt (currently about Y27 trillion or $192.9 billion) and funds for a high-speed underground rail line (Y1 trillion or $7.1 billion). Foreign-oriented programs also get a boost: Y32.7 billion ($233.6 million) for developing country aid and Y50 billion ($357.1 million) for art and cultural exchanges. A savings in administrative costs of Y760.5 billion ($5.4 billion) shows that Tokyo remains committed to shrinking the size and the cost of government, a policy initiated in the early 1980s.

From an aggregate standpoint, the additional funding will push total spending for FY 1989 over Y66.3 trillion ($473.7 billion), a 7.2 percent increase over the revised FY 1988 budget. Deficit borrowing will decline to just over 1 percent of the total budget, a far cry from the 32.7 percent level at the beginning of the decade. The additions to public works outlays and business support programs will help counteract the deflationary effect of balancing the budget.

Jon Choy

Cabinet Sets FY 1990 Spending Plan

Prime Minister Toshiki Kaifu's cabinet on December 29 approved the fiscal plan for the year beginning April 1, 1990, paving the way for Diet consideration of the spending measure. At Y66.3 trillion ($473.4 billion at Y140=$1.00) the initial budget for FY 1990 is nearly 10 percent more than the comparable FY 1989 plan. The gain surpasses any initial increase of the previous decade and virtually equals total spending in the revised FY 1989 budget. Although most of the increase is nondiscretionary, discretionary spending is up nearly 4 percent as well. Tokyo's commitment to foreign aid and defense is unmistakable, as is its continued focus on stimulating domestic demand.

A review of discretionary spending shows a familiar pattern: Tokyo continues to favor certain categories at the expense of others (see Table 1). At

Table 1: Summary of General Account Outlays, FY 1989-FY 1990

(in billions of yen)

	Initial FY 1989	Initial FY 1990	Change
Discretionary Items			
Social Security	Y10,894.7	Y11,614.8	6.6%
Education and Science	4,937.1	5,112.9	3.6
Pensions	1,855.8	1,837.5	-1.0
Defense	3,919.8	4,159.3	6.1
Economic Cooperation	733.9	784.5	6.9
Public Works	6,130.7	6,148.0	0.3
Disaster Reconstruction	66.7	66.7	0.0
Small Business Measures	194.2	194.3	0.1
Food Control Programs	418.2	395.2	-5.5
Energy Measures	527.5	547.6	3.8
Other	4,051.9	4,198.3	3.6
Reserves	350.0	350.0	0.0
Total	34,080.5	35,409.1	3.9
Nondiscretionary Items			
Transfers to Local Governments	13,368.8	15,275.1	14.3
Debt Service	11,664.9	14,289.3	22.5
Transfer of NTT Proceeds to Public Works	1,300.0	1,300.0	0.0
Total	26,333.7	30,864.4	17.2
Total	60,414.2	66,273.6	9.7

the top of the favored list for FY 1990 is foreign economic cooperation with a 6.9 percent increase, followed by social welfare (6.6 percent) and defense (6.1 percent). The increase in economic cooperation includes an 8.2 percent expansion of Japan's official development assistance program. The initial Ministry of Finance proposal contained only a 5.9 percent increase in ODA, but the Ministry of Foreign Affairs argued successfully for a heftier raise (see article in this issue). The jump in social spending reflects government preparations for the increasing number of retirees that are expected in the coming decade. After years of neglect, the growth of social welfare spending will outpace that of defense. The planned expansion of defense outlays, nonetheless, will allow the Japan Defense Agency to complete the current five-year procurement plan (see following article). Despite the increase, defense spending is projected to fall below the politically sensitive level of 1 percent of gross national product due to estimated economic growth for FY 1990 of between 4 and 5 percent in real terms (see article in this issue).

Increases in spending for education/science and energy programs represent victories for far-sighted bureaucrats. Sharply higher energy consumption and a carefree attitude about conservation have made planners within the Ministry of International Trade and Industry edgy. The growth of science-related spending represents, at least in part, a consensus that Japan must devote more money to basic research, not only to support continued advances in commercial technology but to expand technological cooperation with foreign countries.

On the nondiscretionary side, booming tax receipts mandate the sharp increase in revenue-sharing with local governments. The leap in debt service costs underscores the government's concern over balancing the budget and reducing the outstanding debt. The transfer of Y1.3 trillion ($9.3 billion) in funds from the sale of government-held shares of Nippon Telegraph and Telephone Corp. again will be channeled into public works spending to bolster domestic demand and improve the quality of life.

The government's estimates of FY 1990 revenues mirror the trends in nondiscretionary spending (see Table 2). Tax and stamp revenues are projected to grow a strong 13.7 percent in spite of the uncertainty surrounding the future of the controversial 3 percent consumption tax. The Ministry of Finance recently announced that it would offer 1.95 million shares of NTT to the public in FY 1990 after having postponed a similar issue in FY 1989 due to unfavorable market conditions. These revenue increases will permit the government to keep its pledge of eliminating new issues of deficit-financing bonds in FY 1990 while also cutting back sharply on the total amount of new borrowing (see JEI Report No. 47B, December 15, 1989).

Table 2: Summary of General Account Revenue Estimates, FY 1989-FY 1990

(in billions of yen)

	Initial FY 1989	Initial FY 1990	Change
Tax and Stamp Receipts	Y51,010.0	Y58,004.0	13.7%
Nontax Receipts	993.2	1,339.6	34.9
Proceeds from Sale of NTT shares	1,300.0	1,300.0	0.0
Bonds	7,111.0	5,630.0	-20.8
Construction	5,780.0	5,630.0	-2.6
Deficit Financing	1,331.0	0.0	-100.0
Total	60,414.2	66,273.6	9.7

The cabinet approved at the same time MOF's outline for the Fiscal Investment and Loan Program, a second capital budget. FILP provides funds to various governmental and semigovernmental organizations that are involved in a wide range of public works. FILP allocations are up sharply in FY 1990 (see Table 3) for social infrastructure (17.2 percent), welfare agencies (15.7 percent) and public housing (12.1 percent). FILP also is a major channel for Japan's foreign aid projects, encompassing the budgets of the Japan Development Bank and the Export-Import Bank of Japan. In line with Tokyo's commitment to increase foreign aid, FILP funds for trade promotion and economic cooperation will rise 12.9 percent.

As for the source of FILP funds (Table 4), the link between FILP and the general account budget is growing increasingly tenuous: funds transferred from the general account budget to FILP through the Industrial Investment Special Account will drop by nearly a quarter in FY 1990 to a nearly insignificant level. Reflecting concern over the aging of Japan's society, the government Trust

Table 3: Fiscal Investment and Loan Program Outlays, FY 1989-FY 1990

(in billions of yen)

	Initial FY 1989		Initial FY 1990	
	Amount	Change	Amount	Change
Housing	Y7,460.6	7.8%	Y8,365.9	12.1%
Public Service Facilities	4,371.3	-1.8	4,222.0	-3.4
Welfare	736.0	11.2	851.9	15.7
Education	520.2	-18.4	554.1	6.5
Small Business	4,176.4	3.6	4,337.8	3.9
Agriculture	924.4	-5.6	876.0	-5.2
Land Conservation and Disaster Reconstruction	357.9	-12.7	328.5	-8.2
Roads	2,576.8	2.6	2,700.1	4.8
Transportation and Communications	2,361.6	5.9	2,304.1	-2.4
Regional Development	676.6	3.7	682.5	0.9
Industry and Technology	758.7	10.4	796.5	5.0
Trade Promotion and Economic Cooperation	1,420.0	21.3	1,603.0	12.9
Capital Utilization	5,930.0	38.9	6,950.0	17.2
Total	32,270.5	9.0	34,572.4	7.1

Table 4: Fiscal Investment and Loan Program Sources, FY 1989-FY 1990

(in billions of yen)

	Initial FY 1989		Initial FY 1990	
	Amount	Change	Amount	Change
Industrial Investment Special Account	Y85.2	-6.6%	Y64.1	-24.8%
Trust Fund Bureau	26,871.3	2.5	28.453.3	5.9
Postal Savings	8,500.0	7.6	7,200.0	-15.3
Pension Contributions	4,310.0	23.1	5,540.0	28.5
Other Revenues	14,061.3	-5.0	15,713.3	11.7
Postal Life Insurance Fund	5,614.0	27.3	6,055.0	7.9
Government-Guaranteed Bonds and Borrowings	2,000.0	-16.9	2,000.0	0.0
Total	34,570.5	4.4	36,572.4	5.8

Fund Bureau will invest sharply more funds from its pension accounts. Receipts from the postal savings system will fall, in contrast, as a result of Tokyo's efforts to reform and liberalize Japan's financial system.

The negotiations between the Ministry of Finance and other agencies over final spending levels went smoothly this year. MOF presented its draft budget to the cabinet December 24 and interministry negotiations ended late December 28. Final increases in a majority of the spending categories (see Table 5) indicate an easing of the fiscal austerity that had stifled spending since the

Table 5: Comparison of Proposed and Approved FY 1990 Discretionary Outlays

(in billions of yen)

	Proposed	Approved
Social Security	Y11,573.2	Y11,614.8
Education and Science	5,028.3	5,112.9
Pensions	1,797.4	1,837.5
Defense	4,135.0	4,159.3
Economic Cooperation	769.1	784.5
Public Works	6,148.0	6,148.0
Disaster Reconstruction	66.7	66.7
Small Business Measures	191.1	194.3
Food Control Programs	395.2	395.2
Energy Measures	534.1	547.6
Other	4,321.1	4,198.3
Reserves	350.0	350.0
Unallocated Expenses	100.0	--

early 1980s. MOF was willing to restore funds for arguably "nonessential" items, such as regional development (former Prime Minister Noboru Takeshita's furusato or home town program, for example, received a Y300 billion or $2.1 billion boost) and advanced railcar development, which was allotted Y520 million ($3.7 million) for a linear-motor test track. Final budget negotiations also yielded more money for such international concerns as import promotion (Y7 billion or $50 million for a Ministry of International Trade and Industry program) and global environmental concerns (a total of Y447 billion or $3.2 billion).

Although the budget now is ready for submission to the Diet, domestic political considerations may delay the process. While business leaders praised the cabinet's budget as successfully addressing the contradictory problems of balancing the budget and expanding public works, opposition parties blasted the spending plan for a dearth of programs that would raise the country's standard of living and provide for the growing elderly population. Equally important, the Japan Socialist Party attacked the budget for including the controversial 3 percent consumption tax. The JSP pledged to do all it could to block passage of the budget in the Diet's upper house, which the ruling Liberal Democratic Party does not control.

Prime Minister Kaifu reportedly has given up hope of getting even the FY 1989 supplemental budget approved by the current Diet, which opened briefly December 25 and immediately recessed. According to press reports, the LDP and the government have agreed to reopen the Diet January 22 (four days after Mr. Kaifu returns from a trip to Europe) and dissolve the legislative body two days later in response to expected moves from the opposition parties. This would set up February 18 as election day for the lower house and delay consideration of both the FY 1989 supplemental budget and the FY 1990 budget until some time after that. The LDP already is planning for a temporary budget if the FY 1990 spending plan is not approved before the start of the fiscal year, an almost certain occurrence.

Jon Choy

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KEIRETSU AND OTHER LARGE CORPORATE GROUPS IN JAPAN

Summary

Large corporate groups, where a number of firms typically share a name and loose financial ties, are a characteristic feature of the Japanese economy. U.S. officials currently are tackling the subject of the groups, which have no direct American counterpart, as part of the Structural Impediments Initiative talks with Japanese negotiators.

In taking an interest in such groups, Washington is traveling in the well-worn footsteps of American and Japanese researchers. Such experts have identified several kinds of industrial groups in their efforts to trace the groups' influence on public welfare and to determine the implications for public policy. The financial keiretsu, groups of firms organized around a large commercial bank, are the best known. These experts have found that the impact of keiretsu and similar groups on the Japanese economy has shifted over time and often is different than one might expect.

Concept of Firm Groupings

"Bigger is better" is a common expression in both English and Japanese. Following this maxim firms in both the United States and Japan often try to increase their effectiveness through affiliations of various kinds with other firms. In other instances firms in both countries split for legal or business reasons but maintain significant ties.

In some cases competing companies merge or form cartels to lower their costs by enabling larger sales volumes or to obtain higher prices due to their increased market power. American economists typically advocate strict limitations on such horizontal combinations in the belief they often harm public welfare.

Horizontal combinations traditionally have been the main concern of policymakers, but today Washington is pressing Tokyo harder on two other kinds of corporate groupings. The first involves linkages between firms that sell to each other. For example, a manufacturer may combine or develop a long-term relationship with a supplier or with a company it supplies, a downstream linkage. Economists generally see more public benefits and fewer public costs to such vertical combinations than they do to horizontal groupings. Washington also is concerned about combinations of firms that are neither competitors nor suppliers of each other. Economists are divided about the adverse -- or positive -- effects of such combinations.

Antitrust policy in both the United States and Japan is most restrictive with respect to horizontal combinations, less so toward vertical linkages and most tolerant of conglomerates. (For details of Japanese policy toward horizontal linkages, see JEI Report No. 20A, May 19, 1989.) However, both the United States and Japan impose some limits, even on conglomerates. For example, in the United States banks may not own manufacturing firms, while in Japan banks generally may own no more than 5 percent of the stock of another business.

Groups of Firms in the United States and Japan

The United States has nearly all of the combinations described above. For example, the leveraged buyouts and the mergers that made headlines in 1989 often involved firms that had diversified into unrelated businesses during the 1960s and 1970s, sometimes with disastrous results. Thousands of U.S. firms have strong vertical links with one another, existing primarily either to sell to a single company (for example, frozen hamburger to McDonald's Corp.) or to sell the product of a single company (McDonald's franchisees.) In addition, some researchers have identified groups of nonfinancial firms under effective control of large banks or other financial services companies.[1] Finally, American entrepreneurs ranging from John D. Rockefeller in the 19th century to Donald Trump toward the end of the 20th have assembled multibillion-dollar corporate empires.

Some American observers of Japan think the process there has gone much further. The name "Mitsubishi" and the Mitsubishi triple diamond logo, for example, are connected with enough services, products and firms to possibly embarrass even Donald Trump. They include the well-known Mitsubishi Corp. (Japan's top trading company), Mitsubishi Motors Corp., Mitsubishi Electric Corp. and Mitsubishi Bank, Ltd. The more obscure Mitsubishi Estate Co., Ltd. (which is in the process of buying a majority interest in Rockefeller Center),

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[1] See, for example, David M. Kotz, Bank Control of Large Corporations in the United States (Berkeley: University of California Press, 1978) and the references cited therein.

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Mitsubishi Pencil Co., Ltd. and Mitsubishi Warehouse & Transportation Co., Ltd. help round out the list of the 22 companies that are traded on the first section of the Japanese stock exchanges under the name "Mitsubishi." That so many firms bear this tag has little to do with the popularity of the name, per se, and even less with the vanity of any mythical Mr. Mitsubishi. However, although not as closely linked as Mr. Trump's enterprises, the firms are related to each other. In addition, dozens of other firms not bearing the same name or using the same trademark are linked to Mitsubishi companies.

The Mitsubishi corporate relationships described above are an example of one of three kinds of corporate groupings in Japan. The best known of these are financial keiretsu (kinyu keiretsu) -- groups of firms organized around a large bank. While member firms may buy and sell to each other, the glue that holds the group together usually is assumed to be mutual stockholding and bank loans to members, supplemented by personnel exchanges and meetings of the leaders. In short, these firms are linked primarily by finances rather than products; the group as a whole has a conglomerate rather than a horizontal or a vertical structure. (However, as shown below, member companies remain separate firms, making the links much weaker than those American groups described as conglomerates, which are organized as a single company.)

Three of the six keiretsu (Mitsui, Mitsubishi and Sumitomo) are direct descendants of the famous World War II era zaibatsu (financial cliques), while the remaining three (Fuyo, Sanwa and Dai-Ichi Kangyo) have less direct links to earlier organizations. The connections in all six, however, are definitely both historical and financial. All six organizations today have matrix-like rather than pyramidal stockholding structures in contrast to the zaibatsu, which were under the control of a holding company. Stockholding -- and influence -- move in both directions between pairs of firms, although loans and personnel are likely to be mainly from the commercial banks and the insurance companies within the group toward the others.

Enterprise Groups and Vertical Distribution Groups

A second major type of interfirm combination is the group organized around an independent firm, often a manufacturer (like Sony Corp.), but sometimes another type of firm, such as a retailer (Daiei, Inc.) or a railroad company (Tokyu Corp.). Japan has dozens of such large independent groups, called enterprise groups. (Some analysts, particularly in the United States, use terms such as industrial keiretsu to describe such groups.) Stockholding in these groups is more pyramidal, strengthening control in the core firm, than in financial keiretsu. In addition, the maximum amount of stock a core firm can own in another nonfinancial company generally is much higher than the 5 percent legal limit for banks -- or even the 10 percent ceiling for insurance companies. The goods and services produced by the group often are complementary, but they need not be.

In each case the core company has the best-known name, which it may or may not lend to other members of the group. It owns the largest shareholdings in other group companies. It also is the most likely source of personnel or technical assistance to other group members, particularly those just beneath it in the group pyramid.

Otherwise, enterprise groups differ considerably. In some groups, such as the Hitachi Group, member firms have moved into a broad range of businesses, such as construction, consumer electronics and financial services. Other groups consist of related companies that produce the same kind of products as the core firm. For example, Victor Co. of Japan, Ltd., the developer of the VHS format for videocassette recorders and today mainly a manufacturer of that product and audio equipment, is 50.8 percent owned by Matsushita Electric Industrial Co., Ltd., which is best known to American consumers for its Panasonic and Quasar lines of consumer electronics products. Were JVC an American company, it would rank well in the upper echelon of the Fortune 500. It is one of 11 large, publicly traded companies generally considered part of the Matsushita Group.

The third important type of enterprise group consists of a core company that has organized its subcontractors -- and their subcontractors -- into a group, with corresponding stock and personnel ties. Toyota Motor Corp. and its hundreds of affiliated companies typify this pattern.

As noted above, the flow of financial and other resources is mostly one-way in all these enterprise groups. The list of the 20 largest stockholders in Matsushita Electric Industrial does not include JVC or much other representation from the Matsushita Group. (One firm, Matsushita Electric Works Co., Ltd., ranks 19th, holding 1.1 percent of the stock.) However, until his death last year, Konosuke Matsushita, the group's founder, ranked eighth, holding 2.1 percent of the shares. This illustrates another characteristic of such groups and one that distinguishes them from financial keiretsu: one family or individual may hold substantial power.

While not centered around a bank, some large enterprise groups have significant holdings in financial services firms. For example, Toyota is the largest individual stockholder, at 40.6 percent, in Chiyoda Fire & Marine Insurance Co., Ltd., Japan's 10th largest nonlife insurance firm. In addition to being the largest lender to Nissan Fire & Marine Insurance Co., Ltd., Japan's 12th largest nonlife firm, Nissan Motor Co., Ltd. has a 7.3 percent stake, making it the second-largest shareholder. By contrast, the leading nonlife firms, Tokio Marine & Fire Insurance Co., Ltd. and Yasuda Fire & Marine Insurance Co., Ltd., are leading members of the Mitsubishi and the Fuyo financial keiretsu, respectively.

The nonlife insurance companies listed above suggest that financial keiretsu and groups organized around independent firms are alternative group structures. Historically, that was the case. New firms outside the old zaibatsu formed their own groups, sometimes known as new zaibatsu, before World War II. Nissan is a leading example. The practice has continued during the postwar years. Such firms are likely to be much younger than companies associated with zaibatsu or their descendants, explaining why company founders still play leading roles in some relatively independent companies, such as Sony.

Today, however, the situation is not that simple. Some of the core firms of the leading independent groups are themselves members of financial keiretsu, at least in name. While few observers believe that Toyota is in need of a lead bank, the firm nevertheless is a member of the Mitsui keiretsu. Nissan belongs to the Fuyo Group. The companies to which they are linked may or may not belong to the same financial keiretsu. For example, despite Toyota's position as the largest stockholder in Chiyoda Fire & Marine Insurance, the insurer belongs to the inner circle of the Fuyo Group. Nissan Fire & Marine Insurance is part of the Dai-Ichi Group, not in the Fuyo Group with Nissan.

Further frustrating efforts at categorization are those companies that, while strongly associated with financial keiretsu, have their own enterprise groups. For example, Mitsubishi Heavy Industries, Ltd., which plays a major role in the Mitsubishi financial keiretsu, has dozens of firms under it.

In short, financial keiretsu and enterprise groups may be related in several ways. In some situations the leading members of financial keiretsu themselves are at the core of other, distinct large groups of firms, a sort of circle within a circle. In others industrial firms are more independent, with some group members linked to a financial keiretsu (intersecting circles) or two or more financial keiretsu (one circle intersecting with two other circles) or with no strong ties at all. Even where the circles intersect, members of enterprise groups often have a high degree of independence from other members of the financial keiretsu.

Finally, some observers have suggested a third major type of corporate group, the vertical distribution group. In some instances manufacturing firms set up distribution systems, including retail outlets, for their products. Such downstream integration could be considered an extension of any of the three types of enterprise groups discussed above, but the upstream firm is likely to exercise control through such means as exclusive sales arrangements in addition to, or in place of, stock ownership. The core company is likely to be upstream from other members of the group, instead of downstream as is often the case with enterprise groups. Moreover, vertical distribution groups raise different policy issues, as will be seen later.

The three types of corporate groups -- financial keiretsu, enterprise groups and vertical distribution groups -- obviously share some characteristics. Buying patterns among the firms are likely to be closer than they are with nonmembers. However, the practices differ considerably among the three types. Japan's Fair Trade Commission estimated in 1983 that sales to another firm within the same financial keiretsu accounted for 20 percent of sales and 12 percent of purchases.[2] While comparable figures for the other two kinds of keiretsu are not available in the aggregate, data for some specific firms are illustrative.

One of Toyota's affiliated companies, Koito Manufacturing Co., Ltd., a leading maker of automotive lighting equipment and the object of an unwelcome -- and widely publicized -- initiative involving American financier T. Boone Pickens, sells 46 percent of its output to Toyota. (For more on Pickens and Koito, see JEI Report No. 37B, September 29, 1989.) Aisin Seiki Co., Ltd., a maker of transmissions, clutches, brakes and other automotive products and another member of the Toyota Group but more than three times Koito's size, sells 70 percent of its output to Toyota. Were it an American company, Aisin would be in the middle ranks of the 500 largest companies listed by sales, about the size of Apple Computer Inc.

For a retail shop locked into a distribution arrangement with a manufacturer, close to 100 percent of the retailer's purchases often come from the manufacturer. However, the manufacturing firm may opt to have retail outlets in its distribution system stock other makers' products, including imports. At the same time, though, manufacturer-controlled retail outlets generate a minority of retail sales in Japan, even in sectors where they are most prominent like consumer electronics.

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[2] Cited in Thomas Roehl, "Japanese Industrial Groupings: A Strategic Response to Rapid Industrial Growth" (unpublished paper, Graduate School of Business Administration, University of Washington, August 1988), p. 6.

A Fair Trade Commission research group consisting of individuals outside government and headed by Professor Toshimasa Tsuruta of Senshu University recently looked at the question of supplier relationships somewhat differently. The FTC panel sent questionnaires to the 200 largest Japanese nonfinancial firms asking them about their supplier relationships. On the question of financial _keiretsu_ versus enterprise groups, the panel found that among those supplied with producer goods, 5.8 percent of the responding firms mentioned membership in the same vertical group while only 2.3 percent cited membership in a horizontal group. (The FTC defined horizontal groups and vertical groups differently than most other researchers. A relationship was defined as vertical or horizontal based strictly on the type of transaction, regardless of whether the core firm was a financial institution. However, in most cases horizontal relations correspond to financial _keiretsu_ and vertical relations to enterprise groups.) The FTC found similar results (3.3 percent mentioning vertical groups, 2.2 percent horizontal groups) for buyers of capital goods.[3]

In looking at specific products or services, the FTC found divergent patterns, however. For some goods and services affiliation mattered little. For example, with mainframe computers only 10 percent claimed to choose on the basis of group membership or being a major customer of the manufacturer. For others, however, the FTC group found a preference for firms with which the customer had an ongoing formal relationship. High on the list of those mentioning group or financial ties were purchasers of pension fund management services (95.9 percent) and buyers of fire and marine insurance (75.3 percent). The FTC group speculated that the lack of competition in price and quality in the latter two industries led firms to decide on the basis of other criteria. However, the FTC also noted that, in all the business lines it studied, most companies dealt with more than one supplier.

More broadly, the FTC group concluded that group membership was not decisive. As noted, in many cases transactions were concluded without any financial ties between buyer and seller. In those where the thread of such a connection appeared, it often came _after_ the establishment of a long-term supply relationship. In general, the panel found that long-term relationships were pervasive, but past dealings were the main reason they continued.[4]

Characteristics of Financial Keiretsu

The FTC study and other research on _keiretsu_ suggest that all three kinds of corporate groups have the potential for economically important linkages, but that the mere existence of such groupings does not necessarily mean those linkages are very important. If anything, vertical distribution groups and enterprise groups may embody more exclusive arrangements than do financial keiretsu. However, most American and Japanese research has focused on financial keiretsu, partly for historical reasons and partly because the story is more dramatic, involving larger firms and conceivably economy-wide control.

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[3] Fair Trade Commission, _Long-Term Relationships Among Japanese Companies: Report by the Study Group on Trade Frictions and Market Structure_ (April 1987), p. 19.

[4] _Ibid._, pp. 6-7.

Table 1 shows the members of the "Presidents' Clubs" for each of the six financial keiretsu. These are the groups whose presidents meet, in some cases as often as once a week, to discuss various concerns. In three of the groups membership mirrors fairly closely that of the prewar zaibatsu, although some turnover occurs and members occasionally have been added during the postwar period. Not all the firms listed participate that actively; Toyota, for example, is described as an "observer" in the Mitsui Presidents' Club. ~~In~~ addition, many firms that have obvious connections with a group are not included. Mazda Motor Corp. is conspicuous by its absence from the Sumitomo list even though, by most measures, it has an extremely close relationship with that group. Mazda was on the receiving end of a well-publicized rescue mission in 1979 and 1980 that involved the coordinated efforts of several Sumitomo companies.[5] Many of the best-known Japanese names, such as Matsushita Electric Industrial, Sony and Honda Motor Co., Ltd., also are missing, but most analysts regard these firms as truly independent. (Each is the core of an enterprise group.)

After April 1 Table 1 will take on a slightly different look. Mitsui Bank, Ltd. will merge with Taiyo Kobe Bank, Ltd., an institution of approximately equal size (see JEI Report No. 35B, September 15, 1989). At a minimum the lead bank in the Mitsui Group, to be renamed Mitsui Taiyo Bank, Ltd., will be larger. Conceivably, the combination of Mitsui and Taiyo Kobe could propel some firms that are particularly important to both to membership in the Mitsui Presidents' Club. In other instances, while membership in the Presidents' Club probably will be unaffected, the new bank may replace other keiretsu banks as the most important lender and stockholder. For example, Nomura Securities Co., Ltd. was once a member of the Sanwa Group and a group member, Toyo Trust & Banking Co., Ltd., is still its largest stockholder. After the Mitsui-Taiyo Kobe merger, the new bank will become both the largest stockholder in and the major lender to Nomura, replacing Sanwa Bank, Ltd., another Sanwa Group member, in the latter position.

Table 2 gives an overview of how the role of the six financial keiretsu centered around Mitsui Bank, Mitsubishi Bank, Sumitomo Bank, Ltd., Fuji Bank, Ltd. (the Fuyo Group), Sanwa Bank, and Dai-Ichi Kangyo Bank, Ltd. in the Japanese economy has changed in recent years. At least since the mid-1970s the percentage of total employment accounted for by firms affiliated with the six groups has shown a steady decline. In part this reflects the heavy concentration of the groups on manufacturing, which has shown a slow but fairly consistent decline over the period in question in percentage terms as an employer, if not in output. (For details, see JEI Report No. 23A, June 17, 1988.)

The second row shows that the six financial keiretsu also have lost a modest amount of ground in their role as lenders, suggesting some loss of market share to banks and other financial services firms not affiliated with them. Since lending is widely believed to be critical in cementing relationships,

[5] For details see Richard Pascale and Thomas Rohlen, "The Mazda Turnaround," Journal of Japanese Studies (Summer 1983), pp. 219-63.

Table 1: Presidents' Club Memberships, October 1, 1989

Industry	Mitsui (24 companies)	Mitsubishi (29 companies)	Sumitomo (20 companies)	Fuyo (29 companies)	Sanwa (44 companies)	Dai-Ichi (47 companies)
Commercial Banking	Mitsui Bank	Mitsubishi Bank	Sumitomo Bank	Fuji Bank	Sanwa Bank	Dai-Ichi Kangyo Bank
Trust Banking	Mitsui Trust & Banking	Mitsubishi Trust & Banking	Sumitomo Trust & Banking	Yasuda Trust & Banking	Toyo Trust & Banking	
Life Insurance	Mitsui Mutual Life Insurance*	Meiji Mutual Life Insurance*	Sumitomo Life Insurance*	Yasuda Mutual Life Insurance*	Nippon Life Insurance*	Asahi Mutual Life Insurance* Fukoku Mutual Life Insurance*
Nonlife Insurance	Taisho Marine & Fire Insurance	Tokio Marine & Fire Insurance	Sumitomo Marine & Fire Insurance	Yasuda Fire & Marine Insurance		Nissan Fire & Marine Insurance Taisei Fire & Marine Insurance
Trading	Mitsui	Mitsubishi	Sumitomo	Marubeni	Nissho Iwai** Nichimen Iwatani International	C. Itoh Nissho Iwai** Kanematsu-Gosho Kawasho
Forestry			Sumitomo Forestry			
Coal Mining	Mitsui Mining Hokkaido Colliery*		Sumitomo Coal Mining			
Construction	Mitsui Construction Sanki Engineering	Mitsubishi Construction*	Sumitomo Construction	Taisei	Ohbayashi Zenitaka Toyo Construction Sekisui House	Shimizu
Food and Beverages	Nippon Flour Mills	Kirin Brewery		Nisshin Flour Milling Sapporo Breweries Nichirei	Itoham Foods Suntory*	
Textiles	Toray Industries	Mitsubishi Rayon		Nisshinbo Industries Toho Rayon	Unitika Teijin	Asahi Chemical Industry
Pulp and Paper	Oji Paper	Mitsubishi Paper Mills		Sanyo-Kokusaku Pulp		Honshu Paper
Chemicals	Mitsui Toatsu Chemicals Mitsui Petrochemical Industries	Mitsubishi Kasei Mitsubishi Gas Chemical Mitsubishi Petrochemical Mitsubishi Plastics Industries Mitsubishi Monsanto Chemical*	Sumitomo Chemical Sumitomo Bakelite	Showa Denko Kureha Chemical Industry Nippon Oil & Fats	Tokuyama Soda Sekisui Chemical Ube Industries Hitachi Chemical Tanabe Seiyaku Fujisawa Pharmaceutical Kansai Paint	Denki Kagaku Kogyo Kyowa Hakko Kogyo Nippon Zeon Asahi Denka Kogyo Sankyo Shiseido Lion
Petroleum		Mitsubishi Oil		Tonen	Cosmo Oil	Showa Shell Sekiyu
Rubber					Toyo Tire & Rubber	Yokohama Rubber

Industry	Mitsui	Mitsubishi	Sumitomo	Fuyo	Sanwa	Dai-Ichi
Glass and Cement	Onoda Cement	Asahi Glass Mitsubishi Mining & Cement	Nippon Sheet Glass Sumitomo Cement	Nihon Cement	Osaka Cement	Chichibu Cement
Steel	Japan Steel Works	Mitsubishi Steel Manufacturing	Sumitomo Metal Industries	NKK	Kobe Steel** Nisshin Steel Nakayama Steel Works Hitachi Metals	Kawasaki Steel Kobe Steel** Japan Metals and Chemicals
Nonferrous Metals	Mitsui Mining & Smelting	Mitsubishi Metal Mitsubishi Cable Industries Mitsubishi Aluminum*	Sumitomo Metal Mining Sumitomo Light Metal Industries Sumitomo Electric Industries		Hitachi Cable	Nippon Light Metal Furukawa Furukawa Electric
Nonelectric Machinery		Mitsubishi Kakoki Kaisha	Sumitomo Heavy Industries	Kubota Nippon Seiko	NTN	Niigata Engineering Iseki Ebara
Electric Machinery	Toshiba	Mitsubishi Electric	NEC	Hitachi** Oki Electric Industry Yokogawa Electric	Hitachi** Iwatsu Electric Sharp Kyocera Nitto Denko	Hitachi** Fuji Electric Yaskawa Electric Manufacturing Fujitsu Nippon Columbia
Transportation Equipment	Mitsui Engineering & Shipbuilding Toyota Motor	Mitsubishi Heavy Industries Mitsubishi Motors		Nissan Motor	Hitachi Zosen Shin Meiwa Industry Daihatsu Motor	Kawasaki Heavy Industries Ishikawajima-Harima Heavy Industries Isuzu Motors
Precision Instruments		Nikon		Canon	Hoya	Asahi Optical
Department Stores	Mitsukoshi				Takashimaya	Seibu Department Store*
Finance					Orix	Nippon Kangyo Kakumaru Securities Orient
Real Estate	Mitsui Real Estate Development	Mitsubishi Estate	Sumitomo Realty & Development	Tokyo Tatemono		
Transportation/ Communications	Mitsui O.S.K. Lines Mitsui Warehouse	Nippon Yusen Mitsubishi Warehouse & Transportation	Sumitomo Warehouse	Tobu Railway Keihin Electric Express Railway Showa Line	Hankyu Nippon Express** Navix Line	Nippon Express** Kawasaki Kisen Kaisha Shibusawa Warehouse
Services						Korakuen

*Unlisted company.
**Member of two or more Presidents' Clubs.

Source: Toyo Keizai, Kigyo Keiretsu Soran (1990), p. 58.

Table 2: Importance of Financial Keiretsu in the Japanese Economy

	FY 1974	FY 1983	FY 1984	FY 1985	FY 1986	FY 1987	FY 1988
Employment*	n.a	n.a.	4.6%	4.5%	4.4%	4.1%	4.0%
Financing**	40.1	38.9	38.1	38.9	37.4	37.7	35.4
Large Corporation Dependence on Borrowed Funds***	46.7	2.6	1.7	4.8	-15.7	5.8	11.1

*As a percentage of employment in all firms.

**As a percentage of lending to firms listed on Japanese stock exchanges. The figure for FY 1974 is for April 30, 1975. Other figures are at end of fiscal year.

***Net short- and long-term borrowing by firms capitalized at more than Y1 billion as a percentage of total internal and external funds.

Sources: First two rows: Toyo Keizai, Kigyo Keiretsu Soran (1975-76 and 1990 editions).
Third row: Bank of Japan, "Financial Statements of Principal Enterprises" in Economic Statistics Monthly, various issues.

this would suggest that over the past 15 years their combined influence has waned only slightly. However, the third row demonstrates that, in fact, the changes between the large banks and their big customers has been dramatic. During the early 1970s big Japanese firms depended on banks and other financial institutions for almost half their funds, but in the late 1970s a change of historical proportions began: firms increasingly were able to finance their activities using retained earnings and depreciation charges.

Beginning in the early 1980s capital market liberalization led firms still further away from banks for their financing needs as the companies moved more and more directly to capital markets, selling bonds and other securities in Japan and abroad. In fact, the table shows that in 1986 these large firms actually were net lenders to the financial system. Only with a capital spending boom of unprecedented proportions in 1988 and 1989 did large firms' demand for funds become substantial enough to again make them significant borrowers in the fiscal year ending March 31, 1989. (This analysis concentrates on large firms because the critical linkage is between them and large banks. Data for all firms show that the falling dependence on bank borrowing has been true for companies of all sizes, although the shift is less dramatic for smaller companies.)

In short, the conclusion to be drawn from Table 2 is that keiretsu firms played a smaller role in the Japanese economy during the 1980s. The data from Table 3, which show stock shareholding, suggest that the results have been similar for each major player. Over the period from FY 1974 to FY 1988 keirestu firms came to hold a smaller percentage of corporate stock than previously, although in most cases holdings have increased modestly during the past four years or so.

Table 3: Importance of Financial Keiretsu Shareholding

(percent of total shares in Japan)

Group	FY 1974	FY 1984	FY 1985	FY 1986	FY 1987	FY 1988
Mitsui	3.07%	2.09%	2.05%	2.08%	2.15%	2.16%
Mitsubishi	3.63	2.49	2.52	2.62	2.74	2.88
Sumitomo	2.02	1.73	1.73	1.68	1.72	1.63
Fuyo (Fuji Bank)	4.27	2.70	2.63	2.62	2.74	3.16
Sanwa	4.28	3.06	2.96	2.95	3.17	3.21
Dai-Ichi	5.59	3.91	3.77	3.75	3.93	4.00
Total	22.86	14.52	14.29	14.36	15.00	15.54
Number of firms	166	162	164	164	164	164

Note: Data for FY 1984-FY 1988 count firms that are members of two or more Presidents' Clubs in both groups. As a result, the sum of the group figures exceeds the total figure for those years.

Source: Toyo Keizai, Kigyo Keiretsu Soran (1975-76 and 1990 editions).

None of these statistics fully describes the perceived differential leadership qualities and goal orientation found in the groups. Despite their size, financial keiretsu may be like the brontosaurus (or apatosaurus), a giant dinosaur with a tiny brain insufficient to ensure the beast's long-run survival on the planet. Some analysts would dismiss the Fuyo, Sanwa and Dai-Ichi keiretsu at the outset, feeling they are ineffective. As evidence, they point to the fact that not only do some firms belong to two or more of these groups, with Hitachi, Ltd. belonging to all three, but the groups often include competing firms, especially two or more trading companies, in marked contrast to the Mitsui, Mitsubishi and Sumitomo groups. To these analysts, these characteristics suggest a lack of cohesiveness in the three.[6]

Of the three former zaibatsu groups, many analysts give high marks to Mitsubishi for being the most goal-directed and having strong leadership. Mitsubishi, for example, is said to impose strict standards, particularly in comparison with Mitsui, in screening potential firms for the use of its name.

The question of keiretsu cohesiveness, in addition to the group philosophy and structure, involves three features: exchanges of stock among members, officers and directors dispatched to other firms and lending. As noted above, Table 2 suggests that lending has become far less important. Table 4, which shows mutual levels of stockholding, reveals that there has been little change in recent years. Further analysis of the figures from which Table 4 are derived suggests that shareholding between pairs of firms within a keiretsu is often smaller than shareholding by individual corporate nonmembers.

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[6] See, for example, Kenichi Imai, "Kigyo Gurupu," in Kenichi Imai and Ryutaro Komiya (eds.), Nihon no Kigyo (Tokyo: University of Tokyo Press, 1989), pp. 144-46.

Table 4: Average Level of Mutual Shareholding Among Keiretu Members

Group	CY 1963	CY 1975	CY 1979	FY 1985	FY 1988
Mitsui	9.9%	17.5%	17.9%	17.9%	17.1%
Mitsubishi	14.3	27.8	26.9	25.2	26.9
Sumitomo	13.0	25.9	27.2	25.0	24.4
Fuyo	7.0	13.8	15.8	15.8	15.3
Sanwa	10.2	14.1	16.9	16.8	16.4
Dai-Ichi	8.3	14.2	14.4	13.3	12.2

Notes: The average level of mutual stockholding refers to the average percentage of a member firm's stock held by all other group members.

Membership in the groups expanded significantly between 1963 and 1975, with ambiguous consequences for levels of mutual shareholding. In addition, the 1963 figures exclude holdings by trust banks.

Sources: For 1963, Richard Caves and Masu Uekusa, Industrial Organization in Japan, p. 64.; for 1975-1988, Toyo Keizai, Kigyo Keiretsu Soran (1980 and 1990 editions).

On the question of sending officers and directors to other firms the data are less complete, and the large banks show divergent trends. Between 1981 and 1989 Mitsui and Dai-Ichi Kangyo banks sent a roughly constant number of high-ranking employees to other firms, while Mitsubishi, Fuji and Sumitomo banks gradually increased their numbers by a cumulative 10 to 20 percent. Sanwa Bank steadily raised its number, resulting in a cumulative increase of 50 percent over the eight years. Of course, with the economy growing, some increase could be expected. However, the increases for Mitsubishi, Sumitomo and Sanwa suggest a rise greater than expected from economic growth alone.

American researchers, often using data from the late 1960s and 1970s, generally have concluded that financial keiretsu have been unable to act in a unified fashion because stockholding, lending, exchanges of officers and directors and traditions together have been too weak to compel such behavior. For example, Richard Caves and Masu Uekusa in 1976 found themselves in agreement with Eleanor Hadley's 1970 conclusion that decisions could at most be influenced, not compelled, adding, "The bank groups show little cohesion except among subgroups of firms, and the cross-ties of ownership are relatively weak."[7] While the data on officers and directors hint at the possibility of having to modify that conclusion slightly, many of the other changes in recent years point in the opposite direction.

Effects of Keiretsu

Keiretsu are far from an overwhelming force in the Japanese economy, but they still may have important effects on the way firms in Japan operate, particularly member firms. Both American and Japanese researchers have addressed this question.

[7] Richard E. Caves and Masu Uekusa, Industrial Organization in Japan (Washington, D.C.: Brookings Institution, 1976), p. 67.

Financing - Obviously the large bank at the core of a financial keiretsu is a subject of interest. Through its lending it conceivably could give members of the group a "break." At the other extreme it might try to exploit its privileged position as a stockholder. Professors Caves and Uekusa, on the basis of data from the 1960s, argue the latter.[8] This vintage 1976 conclusion fits neatly with a very recent study that found firms abandoning their main banks for securities markets, even though this alternative made them more dependent on their own earnings in fund-raising -- in technical jargon, more "liquidity constrained."[9] Putting these researchers' arguments together, a keiretsu's non-financial members may have traded some of the ability to borrow in good times and bad that comes from their close keiretsu ties for the better deals they can get on funds raised in other ways, especially in securities markets.

Keiretsu as insurance - This argument suggests that keiretsu firms form kind of a mutual insurance group. In this case, if a given firm gets into trouble, it can count on keiretsu members to help bail it out, as the Sumitomo Group clearly did with Mazda. The "insurance premiums" keiretsu firms pay for this benefit are the foregone opportunities to make higher short-run profits by, for example, shopping around for lower rates from a bank other than its main bank or working out deals with a firm other than the group's trading company.

Just as one swallow does not suggest a spring, one Mazda-type episode does not confirm a keiretsu as an insurance set-up. But, if the hypothesis carries some truth, firms getting "insurance" should have more stable earnings than those that do not. Iwao Nakatani of Osaka University argues that keiretsu in general have worked to have a stabilizing effect on the operating performance of member firms.[10] However, Akiyoshi Horiuchi of the University of Tokyo and two other researchers have argued that their research casts doubt on Professor Nakatani's hypothesis, although they allow that in exceptional circumstances a keiretsu bank may find a Mazda-type rescue in its interest merely to salvage its own reputation as a monitor of lending.[11]

Keiretsu and profits - For most American firms at least, profits are the bottom line. The results from Professors Caves and Uekusa, Nakatani and Roehl for the 1950s and through 1975 are fairly consistent: keiretsu may have been

[8] Ibid., p. 82.

[9] Takeo Hoshi, Anil Kashyap and David Scharfstein, "Bank Monitoring and Investment: Evidence From the Changing Structure of Japanese Corporate Banking Relationships," National Bureau of Economic Research Working Paper No. 3079, August 1989, p. 25.

[10] Iwao Nakatani, "The Economic Role of Corporate Grouping" in Masahiko Aoki (ed.), The Economic Analysis of the Japanese Firm (Amsterdam: Elsevier, 1984).

[11] Akiyoshi Horiuchi, Frank Packer and Shin'ichi Fukuda, "What Role Has the Main Bank Played in Japan," Journal of the Japanese and International Economies, No. 2, 1988, pp. 159-180.

more profitable in the earliest postwar years but were, if anything, less profitable by the 1970s.[12]

What about more recently? A comparison is difficult because keiretsu firms as a group differ in many respects from other companies. Simple profitability comparisons of the members of the Presidents' Clubs with other firms suggest that keiretsu groups generally were less profitable between FY 1984 and FY 1988 than either all manufacturing firms or all Japanese companies. However, this conclusion is complicated by the inclusion of trading companies, which have unusual profitability characteristics, in the keiretsu group figures.

For example, in FY 1988 all firms traded on Japanese stock exchanges had a rate of return on sales of 3.9 percent; manufacturing firms earned 5.8 percent. The six keiretsu, excluding financial firm members, varied in profitability from 1.88 to 3.47 percent. In other words, none of the keiretsu equaled the economy-wide averages. Excluding trading companies from the keiretsu figures lifted average profitability to 5.3 percent, above the average of all firms but below the manufacturing average, a striking result considering that without trading companies and financial firms, keiretsu overwhelmingly are made up of manufacturing companies. The FY 1988 result is not unique: for none of the years from FY 1984 to FY 1988 could keiretsu firms, excluding trading companies, equal the overall average for manufacturing firms.

Such figures can be questioned on various grounds. The rate of return on equity rather than sales would be a more apt comparison, for example, because keiretsu firms may differ from others in their degree of vertical integration. If less integrated, they could be expected to have a lower rate of return on sales than a more integrated firm with the same rate of return on equity. A priori, however, it is not clear whether such problems bias the figures one way or the other. On balance, the recent figures reinforce the impression conveyed by earlier data that keiretsu firms, as a group, still are less profitable than their independent counterparts.

Keiretsu and Other Corporate Groups as a Policy Issue

American and Japanese economists could be forgiven for thinking that all their studies had put the keiretsu issue to rest. Financial keiretsu appear to resemble the lumbering brontosaurus more than the terrifying tyrannosaurus and, like both, seem headed for eventual demise. Certainly American policymakers would appear to have other things to worry about. Yet, Washington has made keiretsu one of the centerpieces of the Structural Impediments Initiative discussions. While press reports suggest that the main concern is financial keiretsu, American negotiators apparently have the enterprise groups in mind as well.

One problem for Washington is the alleged tendency of Japanese firms to stick with an established supplier and to avoid shopping around for the best price. As noted above, such practices are more common for transactions within enterprise groups than among members of financial keiretsu. Wherever they occur, however, these exclusionary business practices tend to keep both new foreign and Japanese firms from becoming suppliers. Tokyo responds that long-term

[12] Cited by Masahiko Aoki, Information, Incentives, and Bargaining in the Japanese Economy (Cambridge: Cambridge University Press, 1988), p. 206.

relationships have many economic benefits, including closer ties that permit the more efficient development of new products, lower inventories and fewer production disruptions.

Washington also may be interested in how financial keiretsu affect the cost of capital. Many U.S. analysts argue that Japanese firms benefit from an unfair advantage in what they have to pay for loans, being able to borrow at lower rates than U.S. firms. Whatever the merits of this argument -- and the merits are debatable -- it certainly does not apply to financial keiretsu. As noted above, if anything, the effect of keiretsu has been to raise the cost of capital for firms in the group.

In addition, Washington is reported to be interested in the effect of financial keiretsu and other corporate groups on the ability of foreign firms to acquire Japanese companies. The interlocking shareholdings in both financial keiretsu and enterprise groups are substantial. Many American experts, and some on the other side of the Pacific, admit cross-stockholding amounts to an effective takeover defense. By themselves, however, the shares of members in a fellow financial keiretsu firm often are too small to prevent a takeover if nonmembers feel otherwise.

As noted in Table 4, mutual shareholding averages between 12 and 27 percent among the six financial keiretsu. This suggests that, in the typical firm, between 88 percent and 73 percent of all shares are held by firms or individuals that are not members of the keiretsu. If these remaining shares are widely dispersed, those held within the keiretsu would be decisive, but the main holders of shares outside the keiretsu often are members of other keiretsu or are other powerful companies. This means, for example, that while a group of Mitsui companies conceivably might band together to try to fight off a takeover of a Mitsui firm, they could be outvoted if some combination of Sumitomo keiretsu stockholders, Industrial Bank of Japan, Ltd. and Nippon Life Insurance Co. feel differently about the takeover of the Mitsui company.

Enterprise groups may be different in this regard. In these cases much larger blocks of stock are in one company's hands. It may be able to thwart a hostile bidder by merely voting its own stock. One has to wonder, however, whether making takeovers of enterprise group companies easier really is in the interest of the Japanese and the American public. While many experts regard takeovers as useful devices to make firms more efficient, others worry about the disruption such actions cause. Some Japanese analysts also are concerned that hostile takeovers, whether or not they involve a foreign company, run counter to the Japanese concept of the firm.

In the case of Japan's enterprise groups, an additional argument that Professors Caves and Uekusa made concerning financial keiretsu may be relevant. They noted that a group of firms that trades with each other often can maximize its total profits by pricing intragroup exchanges at competitive levels and selling to outsiders at whatever the market will bear. As a sweetener for member firms supplying intermediate products to price sales to group members at less than what they could otherwise get, a series of payments might be necessary.[13]

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[13] For details of this argument, see Caves and Uekusa, op. cit., p. 61.

Messrs. Caves and Uekusa found the evidence for this argument unconvincing for financial keiretsu, but for at least some enterprise groups, where intragroup sales are much more important, it may be correct. As applied to the Toyota Group, for example, Koito may lower its prices and forgo some profit on its sales to Toyota in order to maximize the profit of the group; however, it obtains some kind of preferential treatment from the rest of the group, now or in the future. The deal is worth it to the rest of the Toyota Group if the motor vehicle manufacturer can sell a larger volume of cars -- albeit at a somewhat lower price -- and earn a higher profit than it could in the absence of such an arrangement.

An American corporate raider poring over Koito's books might see only part of this quid pro quo, the low price of Koito products sold to Toyota. In other words, a successful bid for the company could result in a higher price for Koito's products sold to Toyota at the expense of the hidden transfers to Koito. Such an outcome, if successful, could raise the price not just of Koito's products but of Toyota's as well, in addition to reducing the profits of both Toyota and Koito once the hidden transfers are added to Koito's profits. In such a case, Koito and Toyota shareholders and Japanese and American car buyers would all be losers, although Detroit could come out ahead.

Finally, Washington no doubt sees a connection between keiretsu and another concern on its list, Japanese antitrust enforcement. Discriminatory buying policies of the kind enterprise groups may practice, for example, are subject to Japanese antimonopoly law. In addition, vertical distribution groups consisting of retailers and manufacturers involve exclusive arrangements of a sort that could be of questionable legality under Japanese antitrust law. Washington apparently would like Tokyo to enforce existing Japanese law against such practices. However, in something of a revolution, many American economists no longer are as certain as they were 10 years ago that such practices damage the economy. They see many benefits accruing, for example, from a manufacturing firm being able to exercise some control over how its products are distributed.[14] This new thinking raises the obvious question as to whether or not Washington wants Tokyo to adhere to stronger antitrust activities than many U.S. economists are convinced are appropriate.

Conclusion

As Washington has put more and more aspects of the Japanese economy under the microscope, Japan's corporate groups could hardly escape its notice. In part, this is because they take several forms. While American policymakers seem to believe they have discovered a dangerous virus, they would do well to take a hard look at the work of a generation of American and Japanese economists, often working together, who have found financial keiretsu, at least, to be fairly benign. Other kinds of Japanese corporate groups may present more serious problems, but research on enterprise groups and vertical distribution groups has been far less extensive. Even where exclusive or preferential buying patterns can be shown to exist, many American (as well as Japanese) economists would argue that the practices may be beneficial to economic welfare.

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[14] For details of this argument, see Lawrence J. White, "The Revolution in Antitrust Analysis of Vertical Relationships: How Did We Get from There to Here" in Robert J. Larner and James W. Meehan, Jr. (eds.), Economics and Antitrust Policy (New York: Quorum Books, 1989), pp. 103-121.

Even granting that the three kinds of corporate groups do sometimes create problems, observers would be reassured if Washington at least confirmed the existence of a specific problem before advocating a rush to the operating room. And Tokyo surely must be wondering what kind of surgery Washington will recommend to rid the Japanese economy of any ills discovered. At this point the United States seems eager for the Japanese government to take up the surgeon's scalpel but not sure how it would like Tokyo to wield it. For example, after Washington trotted out a survey of buying practices of Japanese firms, questions arose over whether transactions among Japanese companies should be regulated to such a degree that Tokyo might have to order private companies to buy from -- or sell to -- different companies than the firms believe is in their business interest.

While the Japanese economy is healthy enough to withstand even considerable economic malpractice, asking a second opinion would seem appropriate. In this case American and Japanese researchers who already have considerable experience on the question could provide such an opinion once they get a clearer description of the latest troublesome symptoms.

For further information, contact Douglas Ostrom.

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The views expressed in this report are those of the author and do not necessarily represent those of the Japan Economic Institute.

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JEI REPORT

A Two-Part Report: A and B

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IN THIS ISSUE:

Yen Loses On Three Continents In 1989 1

LDP, Opposition Parties Test Waters For Possible Coalition 4

Tokyo Adds To Impetus For Cambodian Peace Settlement 6

Japan Defrosts China Ties 7

Japan-EC Update 9

Notes: SII Talks 10

Yen Loses On Three Continents In 1989

As experts sort out the events of 1989 affecting Japan, they may be struck by an apparent paradox. During the year Japan's economic performance continued to dazzle as its growth rate stayed comfortably ahead of almost all other industrial countries and fears of a Japanese economic juggernaut increased among Americans. And how did its currency do on world currency markets? The yen went down in value -- not just against the dollar but also against most European currencies and those of Japan's important trading partners in Asia.

The yen dropped 7.1 percent against the dollar during 1989 from its average 1988 level, reversing three straight years of significant advances (see Table 1). From the end of 1988 to last year's close the yen lost 11.8 percent. On the same basis the British pound was virtually the only major currency against which the yen managed to stay even, losing a scant 1.2 percent. This development was comparable to that of a recent world series champion suddenly sharing the cellar with a perennial also-ran. The yen also lost ground against the South Korean won, the Singaporean and the Hong Kong dollars and the New

Taiwan dollar, all of which were relatively unchanged against the U.S. dollar (see Table 2).

Table 1: Yen-Dollar Exchange Rate, 1984-89

(monthly average, Tokyo interbank market)

	1984	1985	1986	1987	1988	1989
January	Y234.0	Y254.1	Y200.0	Y154.5	Y127.6	Y127.2
February	233.7	260.3	184.6	153.5	129.2	127.8
March	225.5	258.4	178.8	151.5	127.3	130.4
April	225.0	251.7	175.6	143.0	125.0	132.1
May	230.7	251.6	166.9	140.5	124.8	138.4
June	233.3	249.0	167.8	144.5	127.1	143.8
July	242.7	241.7	158.7	150.2	133.1	140.7
August	242.2	237.2	154.1	147.6	133.6	141.1
September	245.2	236.9	154.8	143.0	134.4	145.1
October	246.9	214.8	156.0	143.5	129.0	141.9
November	243.3	203.9	162.7	135.3	123.2	143.5
December	248.0	202.8	162.1	128.4	123.6	143.6
Annual Average	237.5	238.5	168.5	144.6	128.2	138.0

Table 2: Changes in the Yen Against Selected Currencies, 1988-89

(other currencies in terms of yen at yearend)

	1988	1989	Percent Change
German Deutsche mark	Y71.55	Y85.18	-16.0%
British pound	229.61	232.30	-1.2
Australian dollar	108.05	113.68	-5.0
Canadian dollar	106.45	124.27	-14.3
Korean won	0.19	0.21	-12.6
Singapore dollar	65.06	75.74	-14.1
Taiwan dollar	4.50	5.52	-18.5
Hong Kong dollar	16.26	18.44	-11.8
U.S. dollar	127.00	143.91	-11.8

Since the now-famous Plaza Accord of 1985 the yen ordinarily had shared top honors with the West German Deutsche mark as the strongest industrial-country currency. During most of the subsequent period the yen has outperformed the Deutsche mark. By the end of 1989, however, the two currencies clearly had been decoupled. Analysts blamed political developments in both countries. In this respect they were about half right.

They exaggerated the effect of political events in Japan. Although 1989 certainly was a tumultuous year by Japanese political standards, with multiple scandals culminating in the Liberal Democratic Party's unprecedented loss of its majority in the upper house, the results on currency markets were questionable, at best. During the first seven months of the year, when most of the turmoil occurred, the Japanese currency lost ground against the dollar, but the Deutsche mark was equally weak. And in the days following the July upper house elections the yen at least held its own. As late as August the yen was slightly stronger against the dollar for the year than the Deutsche mark.

The experts, however, were on firmer ground in offering a political explanation based on events in Europe. The accelerating pace of change in Eastern Europe, particularly in East Germany, decisively broke the connection between the yen and the Deutsche mark during the last three months of 1989. Just as the United States and Japan were mostly bystanders as the drama unfolded, their currencies took a definite back seat to those of European countries. Between October and the end of the year the yen hardly budged against the dollar, but both were weak against the Deutsche mark. Had the yen equaled the late 1989 strength of the Deutsche mark against the dollar, the Japanese currency would have ended the year very close to its all-time high of just over Y120=$1.00. Instead, it finished in New York at Y143.91=$1.00.

For the time being, the Deutsche mark obviously is benefiting from the euphoria over events in Eastern Europe. But its prospects over the next year or two depend on the size of capital flows into and out of West Germany, trade between the two blocs and the social costs of integrating the economies, to name only a few influences. Even if Eastern Europe gives the West German economy a big boost, the Deutsche mark could weaken. Positive economic developments do not necessarily bring in their wake a strong currency.

Japan provided proof of that assertion during the last half of 1989. As noted, the Japanese economy remained buoyant. Yet the yen hardly moved against the dollar in the face of interest rate increases in Japan and drops in the United States -- policy changes that normally would be expected to push the Japanese currency up. Continued economic growth, if anything, had a negative effect on the yen. Not only did widening labor shortages heighten inflationary fears, but imports continued to grow in tandem with the economy, reducing the trade surplus and thereby weakening a factor that normally would bolster the yen.

The drop in the yen's value during 1989 came as a modest surprise to many forecasters, who had expected the Japanese currency to rise slightly over the course of the year. Experts seem determined not to make the same mistake in their outlooks for 1990. An early January survey by Nihon Keizai Shimbun of 41 Japanese experts and 22 foreign analysts showed forecasters to be cautious. None was willing to say that the dollar would drop below it previous low of Y120, even temporarily, during the year. But several thought the dollar could be worth as much as Y160 sometime during 1990.

As a group the Japanese participants, drawn mostly from the ranks of business economists, were slightly more pessimistic about the yen than the others, mostly economists at American and European banks. The midpoint of the range of estimates by the Japanese polled was Y146, for the foreign analysts surveyed Y142. This suggests that the two groups felt that, while the yen would have its ups and downs, its 1990 average would be almost exactly the same as its 1989 yearend value. If the analysts could agree on anything, however, it was that this consensus forecast was wrong. Virtually everyone expected considerable movement in the yen-dollar exchange rate in 1990; they just could not agree on the direction.

Douglas Ostrom

LDP, Opposition Parties Test Waters For Possible Coalition

The phrase "politics makes strange bedfellows" might apply to Japanese politics, depending on the outcome of the expected February 18 lower house elections. Anticipating what may be a fluid political scene following the House of Representatives contests, members of the ruling Liberal Democratic Party and some opposition parties have been floating the idea of an LDP/opposition coalition as a means of facilitating Diet action on a number of difficult issues.

The LDP's public approval rating has improved considerably since its trouncing in the July upper house elections, prompting Prime Minister Toshiki Kaifu to declare January 5 that the ruling party will win a majority when voters go to the polls next month. He also dismissed the notion that the LDP should contemplate a coalition government in the event his prediction proves overly optimistic.

However, senior party officials believe the chances of the ruling party hanging on to all of the 293 seats it currently holds in the 512-seat lower chamber are problematic. Of the factors that affected the House of Councillors' outcome, it still is unclear to what extent the electorate has "forgiven" the LDP for the involvement of some members in the Recruit Co., Ltd. influence-peddling affair. The ruling party's support among previously stalwart agricultural groups also has been weakened due, in part, to the LDP-led government's acquiescence to U.S. pressures that it decontrol beef and orange imports. But what may be the greatest area of uncertainty is whether the electorate will accept the ruling party's attempt to reform the controversial consumption tax (see JEI Report No. 46B, December 8, 1989).

For these reasons, certain senior LDP members have voiced an interest in a coalition with some opposition parties to ensure the continuation of a conservative-led government. "In order to guarantee political stability, we will have to consider forming a coalition," Takujiro Hamada, an influential LDP member, was quoted as saying recently. Former Prime Minister Noboru Takeshita, in fact, proposed December 14 that the LDP consider forming a "partial coalition" with some of the opposition parties. Masayuki Fujio, former chairman of the LDP Policy Affairs Research Council, endorsed Mr. Takeshita's idea, telling his Diet colleagues that this would facilitate better policy coordination. "Telling the [Japanese] people which way we are going to head is important to give them feelings of assurance," he reportedly stated. Although none of the trio explicitly mentioned Komeito or the Democratic Socialist Party as possible coalition partners, ruling party members have acknowledged that these two centrist-leaning parties are the most likely candidates.

Shin Kanemaru, former deputy prime minister and head of the Takeshita faction, came forward December 26 with an even bolder approach: formation of a "broad coalition government centering on the Liberal Democrats and the right wing of the JSP [Japan Socialist Party]." Like the former prime minister, Mr. Kanemaru, who has said that the ruling party's prospects of winning a comfortable majority in the lower house races are "tough," feels that forming a "grand

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JAPAN'S RELATIONS WITH THE "SOVIET BLOC"

Summary

The democratization that is sweeping through Eastern Europe and the general easing of East-West tensions have created new foreign policy challenges for Japan. One of its most immediate tasks, according to Prime Minister Toshiki Kaifu's major policy speech January 9 in West Germany, is to provide economic and technical assistance to the reformist Eastern European countries. Tokyo hopes not only to improve its relations with these countries but to demonstrate to its allies that Japan is willing to use its economic might to play a leading role in stabilizing the post-Cold War international order. Japanese business will remain cautious in developing ties with the eastern bloc, however. The extent to which Japan's economic relations with this region blossom -- a development several Eastern European governments have encouraged -- will depend on how well these countries make the transition to more market-driven economies.

The relaxation of East-West relations resulting in part from Soviet party leader Mikhail Gorbachev's glasnost policy also has created a more favorable environment for improved Japanese-Soviet relations. Since the close of World War II when the Soviet Union seized four islands northeast of Hokkaido -- the so-called Northern Territories -- relations between Tokyo and Moscow have been icy, and the two countries have yet to conclude a peace treaty. Bilateral trade also has been limited due in part to this long-standing disagreement. In need of Japanese capital and business expertise, Moscow recently has pushed for expanded bilateral economic ties independent of the territorial dispute. However, Japanese businessmen contend that their decisions concerning Soviet ventures will continue to hinge primarily on potential profitability rather than political factors.

Japan Economic Institute 1000 Connecticut Avenue, N.W., Washington, D.C. 20036 202-296-5633

Japan's European Initiative

Prime Minister Toshiki Kaifu kicked off a busy 10-day tour of Europe January 9 by expressing Japan's intent to help the fledgling democratic movement in Eastern Europe take firmer root and prosper. "It is incumbent upon us, the industrialized democracies, not to fall into complacency for having made the correct choice for freedom, democracy and the market economy," Mr. Kaifu told his West German hosts only blocks from the Berlin Wall. The Japanese government believes that developments in Eastern Europe will affect the structure of a new postwar international order and, thus, have extensive ramifications for the stability of the Asia Pacific region, he stated.

In what was billed as a major policy address on Japan's diplomacy in the new post-Cold War era, the prime minister pledged substantial injections of Japanese financial and technological assistance to Poland and Hungary. The almost $2 billion of assistance will include: $500 million in loans from the Export-Import Bank of Japan to each of the two countries over the next three years; $350 million in trade insurance to cover Poland's imports from Japan and other trade expenses; an increase from $200 million to $400 million worth of trade insurance for exports to Hungary; a $25 million grant for emergency food assistance for Poland; and $25 million in technological cooperation for both Poland and Hungary.

Tokyo's long-awaited aid package follows up several actions it took late last year to help certain Eastern European countries make the transition to a market-driven economy. In October the government announced the rescheduling of some Y56.3 billion ($402.1 million at Y140=$1.00) worth of Poland's debt. The following month Tokyo agreed to provide $200 million in official development assistance to Poland and Hungary, of which $150 million in low-interest loans will go to a fund created by the Group of 24[1] to help stabilize the Polish currency (see JEI Report No. 42B, November 3, 1989).

Reinforcement for the Group of 24 plan, in turn, came in December when Tokyo agreed to contribute an as-yet undetermined amount of capital to a $12 billion Eastern European development bank proposed by French President Francois Mitterand. Under the Mitterand plan a European Reconstruction and Development Bank for Eastern Europe, backed by 34 countries, would be established to support economic reforms in the eastern bloc. The 12-nation European Community has promised to put up a majority of the capital and would like Japan and the United States to contribute 8.5 percent each. Among the other potential participants are the six members of the European Free Trade Association, Canada and Australia.

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[1] The Group of 24 is made up of the 12 European Community member states (Belgium, Denmark, France, West Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain and the United Kingdom), the six member states of the European Free Trade Association (Austria, Finland, Iceland, Norway, Sweden and Switzerland), Canada, the United States, Japan, Australia, New Zealand and Turkey.

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Mr. Kaifu's most recent pledge makes Japanese assistance to Eastern Europe second only to West Germany's promise of some $2.7 billion; U.S. aid to this region is expected to come to about half the Japanese level. Some Japanese analysts have pointed out that the magnitude of Tokyo's assistance is all the more significant in view of the fact that, unlike the United States, there is no Eastern European ethnic constituency in Japan.

In his "Berlin Wall" address Mr. Kaifu officially gave the green light to Poland and Hungary to begin negotiations with Japan on an investment protection treaty. Tokyo also intends to send a special mission to each of these countries in April to study the investment climate and "socioeconomic structures," the prime minister said. Mr. Kaifu emphasized that Japanese empathy for the economically beleaguered eastern bloc stems from its own immediate postwar experience, pointing out that Japan's capitalist economy and democratic political system are responsible for the tremendous prosperity it enjoys today. He held out the prospect of aid for East Germany, Czechoslovakia, Bulgaria and Romania further down the road but stressed that any economic assistance would be contingent on these countries' efforts to reform their political and economic systems.

The objective of Mr. Kaifu's mission carried perhaps more import than simply an aid announcement. The prime minister undertook his most extensive overseas trip since assuming office last August -- a tour that by January 18 will have taken him to West Germany, Belgium, France, Britain, Italy, Vatican City, Poland and Hungary -- to demonstrate Japan's willingness to play a meaningful role in helping to develop a new international order. Until recently the basic direction of Japan's policy toward the Soviet satellites was determined by the U.S.-Soviet Cold War. But as Soviet party leader Mikhail Gorbachev's policy of glasnost seems to be easing the tensions that circumscribed East-West relations during most of the postwar period, the individual countries that comprise the Western alliance and the Soviet bloc also seem to be reevaluating their own responses to members of the other group.

In Tokyo's view this apparent loosening of the postwar bipolar power configuration means that all nations, including Japan, must endeavor to help create a new, stable order.[2] Thus, the Japanese government, through its Eastern European initiative, in effect is acknowledging what the United States and other trading partners have urged for the past several years: Japan's tremendous economic power warrants a more active diplomacy that supports the interests and the needs of industrialized democracies. Mr. Kaifu's European initiative therefore may be viewed as Tokyo's effort to define more of a leadership role for itself within the Western alliance.

Broad foreign policy interests aside, Tokyo also undeniably regarded this diplomatic mission as an opportunity to cultivate closer relations with Western Europe. Japan's ties with the European Community historically have been weaker than the U.S.-Japan relationship. By providing economic assistance to the eastern bloc and helping Western Europe stabilize the continent, Tokyo hopes to build a reservoir of goodwill that will prevent formation of a "fortress Europe" as EC members formally integrate their economies by 1992. This

[2] Hisane Masaki and Takashi Kitazume, "Contributing to Stability Will be Aim of Foreign Policy," Japan Times, December 23, 1989.

task is all the more urgent since the dramatic changes in Eastern Europe create the potential for an even larger European economic bloc. There also is a view that Tokyo wants to develop closer ties with Western Europe to create greater leverage in its dealings with the United States on various trade disputes.

Official statements have underscored the benefits to be derived from closer relations. Mr. Kaifu urged that Japan and the countries of Western Europe expand cooperative efforts as "global partners" to better cope with the challenges ahead. Rather than dwell on Tokyo's apprehensions about "fortress Europe," the prime minister heartily endorsed the EC integration plan as one that will create a politically strong and economically robust Europe, an imperative element in helping shape a new global order.

On the sensitive subject of German reunification, Mr. Kaifu tread a fine line, not wanting to alienate European countries that may view such a prospect with trepidation, given Germany's past efforts to dominate the continent. Mr. Kaifu acknowledged the German people's "justifiable desire" for unification but expressed his wish that this evolve from within a "framework of peace and stability."

Further demonstrating Tokyo's interest in a higher profile role in Western alliance politics, the prime minister stressed the need for a coordinated Japanese, American and European policy toward China. Although condemning Beijing's suppression of the 1989 student-led democracy movement, Mr. Kaifu discouraged the continued isolation of China by Europe and the United States on the grounds that this creates a potentially destabilizing influence in the Asia Pacific region. He also pledged Japan's continued efforts to establish formal relations with North Korea under suitable circumstances and to facilitate a peaceful solution of the Cambodian problem.

In addition to improving relations with both Eastern and Western Europe, Mr. Kaifu's diplomatic foray was intended to send some important signals to the Soviet Union concerning Japan's desire to improve bilateral relations -- but on Tokyo's terms. Some Japanese aid officials were said to be hoping that Moscow will view Japanese assistance to Eastern Europe as a positive gesture, particularly since the aid could ease the Soviet Union's financial obligations to the region.

However, there appears to be another body of opinion within the Japanese government that would like to see the Kaifu initiative serve as a warning to the Soviet Union in that Japan, a country with which Moscow never signed a peace treaty after World War II, has moved into its sphere of influence in a major way. As a Foreign Ministry official reportedly stated, "Japan's flexing its financial muscle in assisting reformist Eastern European countries [hopefully] will force the Soviet Union to sit up and take notice." Moreover, Mr. Kaifu used his Berlin Wall speech to caution Western European allies not to be seduced by glasnost. The Soviet Union remains a military superpower that has yet to apply "new thinking" to Asia, the prime minister warned. He singled out Soviet occupation of the islands north of Hokkaido claimed by Japan as further evidence of distrustful behavior.

Economic Relations with Eastern Europe: Proceed with Caution

Japan's trade relations with Eastern Europe to date have not been extensive (see Table). Japanese business representatives cite several reasons for

Japan's Trade with Eastern Europe, 1980-88

(in millions of dollars)

	1980	1985	1986	1987	1988
Eastern Europe					
Exports	$807,217	$563,759	$682,026	$716,673	$775,831
Imports	225,760	316,214	344,519	475,903	691,611
Trade Balance	551,457	247,545	337,507	240,770	84,220
Bulgaria					
Exports	65,316	123,421	160,513	117,222	160,590
Imports	22,071	22,118	18,087	24,851	49,546
Trade Balance	43,245	101,303	142,426	92,371	111,044
Czechoslovakia					
Exports	63,466	56,935	61,759	63,086	48,243
Imports	49,379	53,110	56,886	80,817	116,891
Trade Balance	14,087	3,825	4,873	-17,731	-68,576
East Germany					
Exports	138,666	137,133	119,293	201,138	154,734
Imports	39,689	43,967	51,883	59,231	92,602
Trade Balance	98,977	93,166	67,410	141,907	62,132
Hungary					
Exports	107,320	83,247	82,271	91,733	101,338
Imports	17,447	52,306	61,265	97,928	163,816
Trade Balance	89,873	30,941	21,006	-6,195	-62,478
Poland					
Exports	228,176	73,214	146,087	166,862	258,037
Imports	61,571	67,443	55,779	75,587	115,989
Trade Balance	166,605	5,771	90,308	91,275	142,048
Romania					
Exports	202,655	89,566	111,476	76,436	52,597
Imports	65,577	65,045	95,415	132,756	142,175
Trade Balance	137,078	24,521	16,061	-56,320	-89,578

Source: Japan Tariff Association

the low level of economic activity in this region. Geographic distance is a not-insignificant factor: Japanese businessmen understandably feel more comfortable pursuing new ventures in their own backyards, particularly when they do not feel an affinity with the area's cultural, political or economic conditions. This factor combined with the eastern bloc's heretofore inflexible centrally planned economies, its lack of convertible currencies and the export restrictions that come with Japan's Cocom (Coordinating Committee for Multilateral Export Controls) membership have added up to unprofitable prospects.

Even as the democracy movement gathers steam, however, the Japanese private sector is reluctant to charge into Eastern Europe. "Of course, I welcome the reforms, but the rapid changes make me confused, too," says Shinichi Ishikawa, general manager of the Soviet department of Sumitomo Corp. "For the time being, we must cope with the situation in the most careful manner."[3]

Daihatsu Motor Co., Ltd., which is interested in setting up a manufacturing facility in Poland, also decided to proceed with caution. The automaker is concerned that, despite ongoing liberalization, it still will experience difficulties in freely exporting Polish-made cars to other nations. Daihatsu officials feel that export restrictions imposed by Comecon (Council for Mutual Economic Assistance), the Soviet bloc's 40-year-old trading system, also must be eased to complement the transition of some eastern bloc countries to a more capitalist system.

Nevertheless, the Japanese private sector expects that as political and economic reforms take root in this part of the world the potential for profitable business activities will improve. And for this reason Japan's business community feels it cannot afford not to be involved in Eastern European developments. Tokyo's unveiling of its ambitious aid program no doubt already has helped create more favorable investment conditions. In an announcement that coincided with Mr. Kaifu's Berlin Wall speech, Suzuki Motor Co., Ltd. revealed January 9 that it had decided to go ahead with plans to assemble subcompact cars in Hungary.

The project is the first of its kind in Eastern Europe involving a Japanese automotive manufacturer. The Y20 billion ($142.9 million) assembly plant -- financed by Suzuki (30 percent), trader C. Itoh & Co., Ltd. (10 percent), a group of Hungarian automakers (50 percent) and the World Bank's International Finance Corp. (10 percent) -- will start turning out cars in 1992 at an initial annual rate of 15,000 units for sale throughout Europe. Most of the money Suzuki and C. Itoh have to put up is expected to take the form of low-cost Ex-Im Bank loans and count as part of Japan's aid package for Hungary.

Polish Prime Minister Tadeusz Mazowiecki has urged active Japanese investment in Poland so his country can become a production base for Europe. "Poland can be a bridge between Japan and Europe as our country is located close to Western Europe," Mr. Mazowiecki said in a January 7 statement strategically timed just prior to Mr. Kaifu's visit. He specifically has requested Japanese expertise in the fields of finance, electronics and communications.

Judging by Mr. Kaifu's enthusiastic endorsement January 4 of greater technical exchanges with the eastern bloc, the Polish leader no doubt had little trouble convincing his guest that Poland needs more of the vaunted Japanese business expertise. The challenge for both Mr. Kaifu and Mr. Mazowiecki will be in convincing the Japanese business community of the commercial benefits.

Although the Daihatsu project still is on hold, other Japanese companies appear more encouraged by what they see happening in Warsaw. Asahi Glass Co., Ltd. announced November 12 its participation in a joint venture with the Polish government to construct a state-of-the-art plant to manufacture sheet glass. The estimated $100 million project, with a planned output of 140,000 metric tons per year, gained momentum when the World Bank's IFC unit agreed to grant loans on soft terms. Trader Toyo Menka Kaisha, Ltd. will team up with Asahi Glass on what at this stage promises to be the largest Japan-Poland project.

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[3] Konosuke Kuwabara, "East Europe Reform May Spur Business Links," Japan Economic Journal, November 25, 1989.

Despite these moves, business analysts are not optimistic that the Suzuki and the Asahi Glass ventures are indicative of a rush of Japanese business into the region. The unsettled nature of political and economic conditions there remains a major concern. In addition, the underdeveloped business infrastructure in many of these countries will continue to be a major disincentive to Japanese investment. Private-sector analysts contend that most Japanese companies will choose to wait at least five years before considering large-scale ventures in the region. Some go so far as to predict that for the next 10 years these economic problems and uncertainties will impede an expansion of trade between Japan and Eastern Europe much above current levels, regardless of progress in democratization and improved East-West relations.[4]

It also is unclear whether the Japanese government will continue to provide billions of dollars of financial assistance to Eastern Europe. Although the United States and Western Europe no doubt will urge Tokyo to accept this as more than just a one-time burden, Japanese aid officials anticipate difficulty repeating FY 1989's $2 billion in expected disbursements due to tight budgetary conditions and demands from "traditional" aid recipients. Moreover, the Japanese people have yet to be persuaded that their tax monies should be used to support Eastern European reformist countries rather than improve their own living standards, which lag behind those of most other Western industrialized nations.[5] As if to forewarn Japan's Western partners that the "well" is not bottomless, officials have sought to portray Tokyo's overall aid effort as a "camphor injection" to ease the reformist countries' transition to more open political and economic systems.

Glasnost and Japanese-Soviet Relations

Political/Economic Linkage - Soviet party leader Gorbachev's policy of openness or glasnost -- a policy that many have acknowledged as opening the way for democratic changes in Eastern Europe -- also improves the prospects for friendlier Japanese-Soviet relations. Actually, Mr. Gorbachev for the past three years has made a concerted effort to usher in an era of improved bilateral relations. His "friendship initiative" began in full force in July 1986 when, as part of a major address on Moscow's Asian policy, the Soviet leader referred to Japan as a "power of top-level significance." That same year saw the conclusion of several agreements that covered a broad range of subjects and, after the deep freeze that had characterized bilateral diplomacy since the mid-1970s, restored regular, working-level consultations, including alternate annual visits by the two countries' foreign ministers. There also was a commitment to continue work toward a peace treaty between the two countries (see JEI Report No. 36A, September 23, 1988).

The dispute concerning Soviet occupation of the islands north of Hokkaido, which Japan calls the Northern Territories, has blocked conclusion of a Japanese-Soviet peace treaty for the past 44 years. The islands in question

[4] Masaki and Kitazume, op. cit.

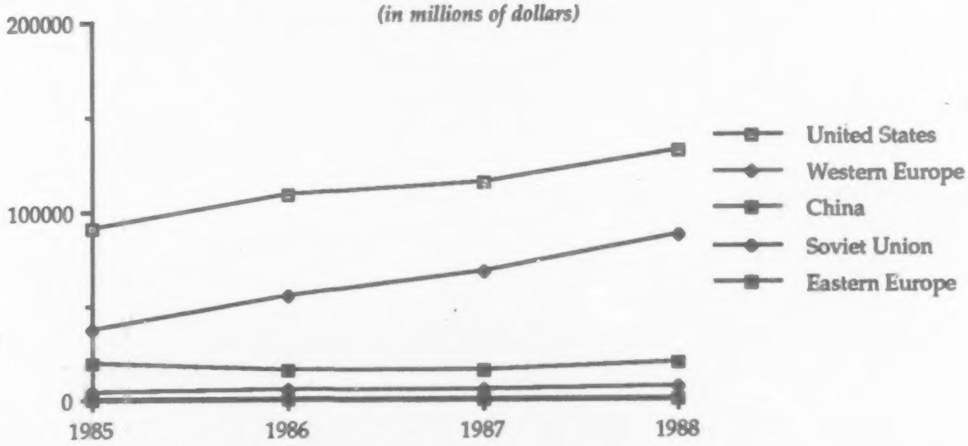
[5] Masaki and Kitazume, op. cit.

-- Kunashiri, Etorofu, Shikotan and the Habomai Island group -- were seized by Moscow at the close of World War II after the allied powers agreed that the Kurile chain should become Soviet territory. To this day the Kremlin doggedly insists that its occupation of the islands is justified under international law. Tokyo, however, has demanded the return of the territory, arguing that these particular islands not only traditionally have belonged to Japan but are not among the territories awarded to Moscow by the allied powers -- a position supported by the United States. The Japanese government has insisted that conclusion of a peace treaty with its Russian neighbor is contingent on settlement of this issue. And it has linked resolution of the territorial dispute to any significant expansion of economic relations with the Soviet Union.

This linkage has been particularly bothersome for the Soviet Union since economic interests appear to be the primary motivation for Moscow's friendlier approach to Tokyo. As with Eastern Europe, Japan's trade with the Soviet Union, relative to other industrial countries, really has never taken off despite the potential offered by geographic proximity and complementary needs (see Chart). At the same time, the Soviet economy sorely needs the shot of adrenalin that Japanese credits and direct investment would provide, particularly in the high technology sector.

Japan's Total Trade with Major Trading Partners

(in millions of dollars)



Japanese business appeared keenly interested in becoming involved in the development of Siberian resources during its energy-panic days of the 1970s. Moscow, in turn, attempted to use Siberian development as a lure for Japanese capital and business expertise, hinting that progress on the Northern Territories might be in the offing; it later refused to budge from its position. Now, however, the vast resources of the Soviet Union's largely undeveloped Siberian region no longer hold such a strong attraction for Tokyo. Major industrial power consumers are using energy more efficiently, oil prices have declined and Japanese industry has advanced technologically, lessening its natural resource requirements.

Bypassing the government, Moscow has urged Japanese business to invest in joint ventures with Soviet enterprises as a means of acquiring Japanese commercial acumen and developing export industries. Japanese businessmen have not forged links in the Soviet Union for many of the same reasons they remain cautious about developing ties with Eastern Europe; the Soviet business infrastructure is very underdeveloped, which, given the inconvertibility of the ruble, spells questionable profitability. In addition, Soviet manufactured imports have little appeal to the sophisticated and quality-conscious Japanese consumer. Japanese business would rather look toward China and Southeast Asia as potential suppliers of low technology, low-priced consumer goods.

Recognizing its position of strength Tokyo shrewdly hangs onto its economic trump card in an effort to force Moscow to adopt a more flexible approach to the territorial problem. During a November 1989 meeting in Tokyo with a senior Soviet politburo member, Foreign Minister Taro Nakayama emphasized that a settlement of the Northern Territories issue would create "great expectations" concerning future bilateral economic cooperation, suggesting that Tokyo has not wavered in its linkage of politics and economics. Nevertheless, the Kremlin continues to stall on the Northern Territories, apparently hoping that it eventually can achieve greater Japanese trade and investment simply through protestations of friendship.

Progress on the Northern Territories? - The November visit to Tokyo of Alexsandr Yakovlev, reportedly one of Mr. Gorbachev's top lieutenants and the architect of glasnost, sparked a flurry of speculation that the Soviet Union was testing the waters for a possible compromise on the Northern Territories question (see JEI Report No. 45B, December 1, 1989). In a November 14 meeting with ruling Liberal Democratic Party secretary general Ichiro Ozawa, Mr. Yakovlev suggested that there might be a "third way" to break the longstanding deadlock over the islands. Although he did not specify exactly what he meant by a "third way," some Japanese political observers speculated that he may have had in mind the return of part of the disputed territory (possibly Habomai and Shikotan), a concession Moscow was willing to make at the time of a 1956 normalization agreement with Tokyo but which the Soviets subsequently withdrew (see JEI Report No. 36A, September 23, 1988).

Mr. Yakovlev the following day quickly denied that concessions on the Northern Territories were in the offing. He explained that what he meant to say was that bilateral discussions should proceed in other, nonpolitical areas, such as economic relations and cultural exchanges, regardless of the status of the territorial problem. This message was reiterated in subsequent statements by Soviet Vice Foreign Minister Igor Rogachev and Soviet Ambassador to Japan Nikolai Soloviev.

At the December 19 close of yet another fruitless session of the bilateral working group on treaty negotiations, Mr. Rogachev urged Tokyo to reconsider its opposition to Moscow's proposal that each side come up with drafts for a peace treaty by early 1990. Japanese officials regard this initiative as a blatant attempt to sidestep the territorial question. The Soviet vice foreign minister insisted that the treaty talks would be more constructive and concrete if both sides prepared drafts for further discussion. He pointed out that the two governments are not closer to resolving the Northern Territories question due primarily to Tokyo's refusal to recognize the "justness" of the Soviet position. Following up this message, Mr. Soloviev, in his New Year's message to the Japanese people, pinned the blame for the lack of bilateral progress in economic, technological and other relations on Japan's demand for the return of the islands.

Despite the unequivocal nature of these statements, some Japanese analysts remain optimistic that the Soviet Union will come forth with some concessions during the course of preparations for Mr. Gorbachev's 1991 trip to Japan. The March visit of Foreign Minister Eduard Shevardnadze will enable these individuals to further test their theory. Although a Diet resolution calls for the simultaneous return of all the islands in question, the Foreign Ministry has indicated that Tokyo may not remain rigid on this point if interim actions lead to the eventual return of the four islands.

The prevailing view among Japanese officials, however, is that the Kremlin will not bend on the Northern Territories question, at least in the coming year. From a domestic political standpoint, the secession movement that is gaining momentum in the Baltic states makes it virtually impossible for Mr. Gorbachev to concede on any territorial question involving another country's claims.

Moscow also places great strategic value on these islands. There are only two practical sea-lanes for the Soviet naval fleet to take out of Vladivostok -- the Korea Strait between South Korea and Kyushu and through the Kurile chain separating the Sea of Okhotsk from the Pacific Ocean. Since the Korea Strait is under continual surveillance by the United States and Japan, the route through the Kurile chain acquires all the more significance. Were the islands to revert to Japan, Soviet access to the Pacific Ocean would be more difficult.

Another consideration that appears to underlie the Kremlin's refusal to relinquish the territory is its concern that the return of the four islands will not completely satisfy Japan. Moscow fears Tokyo might then demand the northern part of the Kuriles as well as southern Sakhalin. Furthermore, Soviet acquiescence on this issue could appear to prove the effectiveness of taking a hard line against the Soviets and encourage further demands in Japan's diplomacy with the Soviet Union. In sum -- _glasnost_ rhetoric aside -- the outlook for resolution of the territorial dispute and formal rapprochement continues to look bleak.

Interestingly, Japanese private-sector representatives maintain that conclusion of a Japanese-Soviet peace treaty would not necessarily open a flood gate of bilateral commerce. In one Japanese businessman's words, "The Northern Territories issue really has no bearing on decisions concerning Japanese-Soviet ventures." Admittedly, some Japanese companies feel constrained by Tokyo's policy and eye with envy the higher profile and greater activity now enjoyed by their Western counterparts in Moscow. But Japanese firms will continue to put their money wherever they expect profits. In the foreseeable future this probably will _not_ be in Siberia.

Soviet Military Threat - There are two schools of thought in Japan on how to handle the Northern Territories dispute. The "entrance theory" holds that to improve relations with the Soviet Union the territorial dispute should be resolved first. The "exit theory" states that the goodwill engendered through cooperation in the economic, technological and cultural fields will enable the territorial dispute to be resolved farther down the road. The Japanese government and a large majority of the private sector firmly subscribe to the "entrance" approach due to their deeply held suspicions about Moscow's designs on the region. They note that during most of the postwar period the Soviet

Union has compiled a record of military activity in the Pacific region that can best be described as hostile and expansionistic.

Judging by Mr. Kaifu's remarks in West Berlin, Tokyo still firmly believes that the Soviet Union poses a serious security threat to the region, regardless of the progress Moscow and Washington have made in the area of arms reduction. The Kremlin has rebutted that this view "conflicts with reality." Soviet Vice Foreign Minister Rogachev in December stressed that the Soviet Union has undertaken many unilateral steps to lower military tension in the region, citing Moscow's decision to cut its forces on its easternmost flank by 120,000 troops as well as its proposal, rejected by Japan and the United States, for regional military talks with Tokyo and Washington.

Tokyo is not swayed by either the statistics or the peace initiative. "The Soviet threat is real and growing," says Lieutenant General Atsushi Shima, commander of the Ground Self-Defense Force's Northern Army. "Modernization of their military capabilities is offsetting any quantitative reduction in forces." U.S. military intelligence concurs with this assessment (see JEI Report No. 40B, October 20, 1989).

Japanese defense officials especially are concerned about the steady buildup of Soviet forces on the northern islands. Moscow in 1978 deployed troops to the Northern Territories and constructed military installations on two of the islands (Kunashiri and Etorofu). The equivalent of an army division and 40 MiG-23 fighter aircraft currently are stationed on these islands. All told, the Soviet Union has 43 divisions on its eastern flank, along with about 100 warships, 140 submarines and some 2,400 aircraft. Given the estimated 390,000 Soviet troops now stationed along the coastal regions of Sakhalin, the Okhotsk Sea and the Kamchatka peninsula, it is no wonder that in Tokyo's eyes Moscow remains a clear and present danger to Japanese security.

As part of its glasnost policy the Gorbachev government has changed the Soviets' diplomatic style, perhaps recognizing that its past heavy-handed activities only heightened anti-Soviet feelings in Japan and caused its island neighbor to increase its defenses in concert with its American ally. Specifically, the harassment created by repeated violations of Japanese air space and seizures of Japanese fishing vessels, which may or may not have drifted into Soviet waters, appears to have decreased.

In late December, for example, Soviet authorities notified Japanese air traffic controllers in advance of the flight plans for 12 Soviet military aircraft that were flying from the Soviet base at Cam Ranh Bay in Vietnam to the eastern coast of the Soviet Union, a course that would take them over the waters south of Okinawa. This courtesy on Moscow's part is all the more significant since the flight path technically did not violate Japanese air space.

Japan remains guarded, however. The years of enmity between the two countries engenders vivid memories for the Japanese. Tokyo's view of the implications of Mr. Gorbachev's efforts to improve relations with the West and bolster the Soviet economy is best summed up by one Foreign Ministry official's remark: "There is no guarantee that helping to improve the Soviet economy will bring an end to Moscow's military adventurism."

Conclusion: Better Atmospherics But Limited Commerce

For the foreseeable future the countries of the Soviet bloc will not have any strong attraction for Japan in economic terms. However, Tokyo probably will remain strongly committed to supporting the Eastern European reform movement in recognition of its responsibilities as a major global power. Mr. Gorbachev's glasnost policy is a historic development that demands a more activist response from Japan. Tokyo, through its Eastern European aid initiative, has indicated to the world that it is ready to expand its diplomatic role in accordance with its economic power.

According to Japanese foreign policy analysts, Japan's new-found diplomatic leadership will not conflict with or diverge from the U.S. approach. Like Washington, Tokyo can be expected to continue conditioning its economic assistance to Eastern Europe on recipients' efforts to implement effective political and economic reforms. Japan also may show more restraint than some of its West European allies in supporting German reunification or greater economic integration of Eastern and Western Europe due, in part, to the objectivity it can show because it lacks a cultural and geographic connection with this continent.

The outlook for Japanese-Soviet relations is unclear. While remaining suspicious of Mr. Gorbachev's ulterior motives, Tokyo nevertheless recognizes that prospects for improved relations are much more likely under his administration and has responded in kind with its own goodwill gestures. Yomiuri Shimbun reported January 5 one such gesture: Japan has decided to support the Soviet Union's bid to join the General Agreement on Tariffs and Trade as an observer.

In an effort to further warm relations, Shintaro Abe, former LDP secretary general, January 13 led a group of LDP Diet members to Moscow. Mr. Abe met January 15 with Mr. Gorbachev to try to facilitate a breakthrough on the Northern Territories/peace treaty logjam. That the Soviet leader did not cancel this meeting due to mounting problems in the Baltic states (but did postpone his January 16 meeting with British Labor Party leader Neil Kinnock) is a strong indication of the importance the Kremlin places on improved bilateral relations. This was not lost on Tokyo: Foreign Minister Nakayama said the Japanese government "welcomed this decision . . . [which] demonstrated the Soviet government's enthusiasm to improve its relations with Japan."

Mr. Gorbachev's success in weathering his current domestic difficulties could have important implications for future Japanese-Soviet relations. If the primary impetus for improved relations indeed comes from the policy convictions of the Kremlin's current leader, any lessening of his political power might wield another setback to the Moscow-Tokyo dialogue.

For further information, contact Barbara Wanner.

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The views expressed in this report are those of the author and do not necessarily represent those of the Japan Economic Institute.

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JEI

REPORT

A Two-Part Report: A and B

NO. 3B
January 19, 1990

IN THIS ISSUE:

OECD And EPA Highlight Japan's Budget Surplus ... 1

Update On Japan's Financial Liberalization 3

Tokyo Pledges Final ODA Loan To Seoul 6

Kaifu's European Tour: Multiple Objectives? 9

Tokyo Expected To Extend Car Export Limits 11

Notes: Japan-China 14

OECD And EPA Highlight Japan's Budget Surplus

The description could be straight out of a news story from either Tokyo or Washington: a large surplus in social security masks a huge deficit in the central government's operations. The budget situation, in other words, is not nearly as good as it looks. In Washington the situation as described has led to substantial handwringing and even a proposal to reduce taxes going into the social security trust fund. The apparent hope is that the unmasked government deficit figure would somehow stimulate calls for an offsetting tax increase to finance ordinary federal government expenditures, leaving the overall budget deficit unchanged.

In Tokyo, however, the situation looks more like an embarrassment of riches. While the central government's budget remains in deficit, the size of that imbalance has declined from about 6 percent of gross national product in fiscal 1979 (ended March 31, 1980) to an estimated 2 percent in FY 1988. As a result, the combined deficit of the central government, the social security fund and local governments shrank dramatically during the early and mid-1980s; in FY 1987 the aggregate deficit was replaced by a surplus. In a so-called into such areas as real estate investment trusts and developing new instruments based on options and futures, the American units of the Big Four brokerage houses -- Nomura Securities Co., Ltd., Yamaichi Securities Co., Ltd., Daiwa Securities Co., Ltd. and Nikko Securities Co., Ltd. -- all reported profits for the last half of 1989. After realizing that their traditional way of doing business (large volume, low-margin trading) did not match U.S. markets, they have moved quickly into new fields. (Interestingly, Japanese subsidiaries of American securities firms have enjoyed increasing success in Japan by offering the same advice to Japanese investors as they do in the United States -- buy and sell recommendations based on exhaustive market research.)

It is unlikely that U.S. or domestic pressure for further changes in Japan's financial markets will diminish since many issues remain unresolved. MOF is finding it increasingly difficult, however, to find a compromise that balances the myriad of competing interests.

Jon Choy

Tokyo Pledges Final ODA Loan To Seoul

Tokyo pledged to Seoul this month the final $690 million installment of a $1.85 billion, seven-year aid package, comprised totally of loans on concessional terms. The new money will be used to expand Seoul's subway system. The exact terms of the lending -- which Japan will administer through the Overseas Economic Cooperation Fund -- will be determined during a fact-finding mission to South Korea. Tokyo indicates that it will not give Seoul any new concessional loans because, as one of the newly industrialized economies, South Korea anticipates being graduated to the status of developed nation in the near future.

The recently announced loan is part of a larger FY 1983-FY 1989 $4 billion economic assistance program for South Korea. The $4 billion deal was concluded following negotiations between the two governments regarding Seoul's $6 billion economic assistance request in 1981. The Export-Import Bank of Japan originally was to extend $2.15 billion worth of loans to South Korea as other official flows -- including funds for export credits and direct investment -- rather than as official development assistance. South Korea had applied for the funding to offset the negative effects of rising oil prices and heavy defense expenditures -- which, in part, play a role in regional defense benefiting Japan, Seoul argued.

However, Ex-Im Bank has made only two loans to South Korea. In December 1983 it committed $42.1 million; four years later it committed another $29 million. The bank has indicated that it is unlikely to pledge new funding to South Korea since economic progress there makes such concessional lending unnecessary. Moreover, just 63 percent of the $1.85 billion in planned OECF loans had been committed by the end of FY 1987 (see Table 1). Due to the strength of its economy in FY 1988 South Korea received no additional loans that year.

Since 1981 when Seoul's net borrowing totaled $288.5 million, it has been a net repayer of loans to Tokyo every year (see Table 2). In the last decade South Korea has received almost no outright grants, although it does continue to receive technical cooperation, considered to be a grant. Technical cooperation has continued to increase every year, surging from $6.2 million in

Table 1: New Loan Commitments to South Korea by Japan, 1980-88

(in millions of dollars)

Year	Amount
1980	$83.8
1981	--
1982	--
1983	189.9
1984	208.4
1985	228.1
1986	264.9
1987	--
1988	212.7

Source: Ministry of Foreign Affairs

Table 2: Japan's Official Development Assistance to South Korea, 1980-88*

(in millions of dollars)

	Grants			
Year	Grant Aid	Technical Cooperation	Loans	Total
1980	---	$6.2	$70.1	$76.3
1981	$0.0	7.0	288.5	295.6
1982	---	8.3	-4.4	3.8
1983	---	9.2	-15.9	-6.6
1984	0.1	11.2	-59.4	-48.1
1985	---	15.1	-19.6	-4.4
1986	---	21.8	-35.5	-13.8
1987	0.2	29.2	-22.8	6.6
1988	---	35.6	-23.1	12.6

*Net disbursement basis.

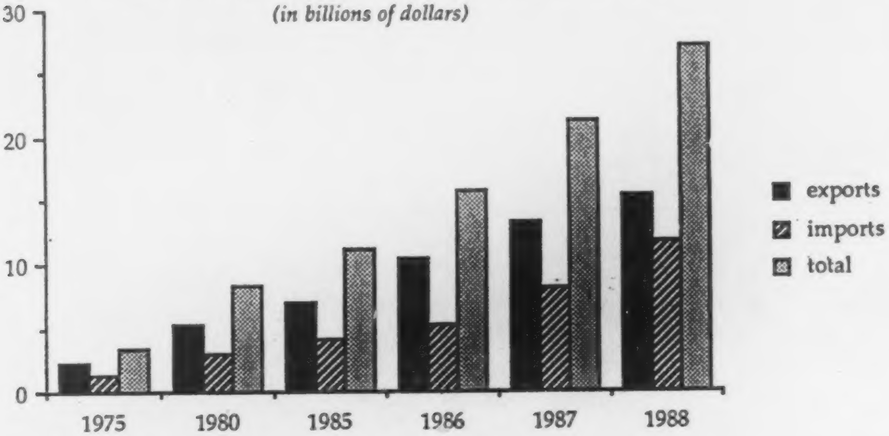
Source: Ministry of Foreign Affairs

1980 to $35.6 million in 1988. This rise, in part, reflects the depreciation of the dollar relative to the yen from late 1985 through 1988. The value of the South Korean won is pegged to the U.S. dollar.

The price competitiveness of South Korea's exports to Japan also benefited from the strengthening of the yen following the September 1985 Plaza Accord agreement. Trade between the two countries has soared in the past decade, reaching $27.3 billion in 1988 (see Chart 1). Japan's imports from South Korea almost tripled, going from $4.1 billion in 1985 to $11.8 billion in 1988. Exports hit $15.4 in 1988 from $7.1 billion three years earlier, resulting in a smaller Japanese surplus. Japan's foreign direct investment in South Korea also has increased significantly since 1985 (see Chart 2). The investment outflow in FY 1988 was $483 million, roughly triple the FY 1985 level (see JEI Report No. 26A, July 27, 1989).

Chart 1: Japan's Trade With South Korea

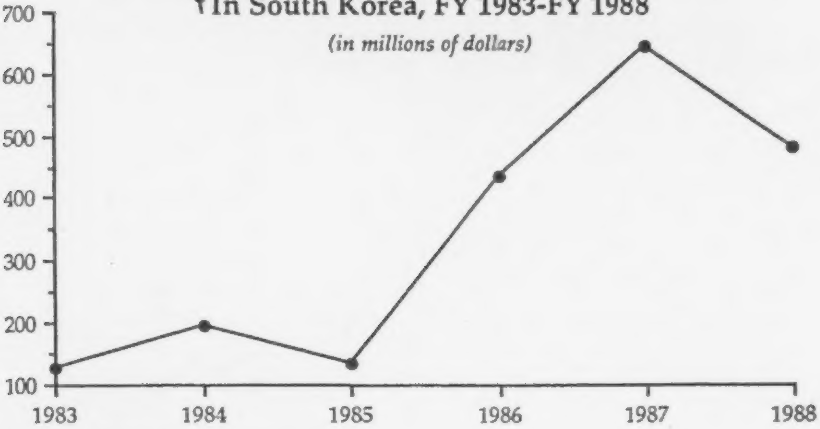
(in billions of dollars)



Source: Ministry of Finance

Chart 2: Japan's Foreign Direct Investment In South Korea, FY 1983-FY 1988

(in millions of dollars)



Source: Ministry of Finance

Japanese lending over the last decade has helped strengthen South Korea's infrastructure, which has resulted not only in a more competitive trade partner but a country more able to extend its help to others, both as a model and financially. Reflecting the progress, Seoul has created its own program to administer foreign aid to developing countries. With the final loan of Japan's economic assistance package in place, Tokyo and Seoul in the 1990s will enter a new phase in their economic relations.

Gretchen Green

reports indicate that public support for the ruling party has declined due to the LDP's failure to reform the controversial 3 percent consumption tax in a way that is more attractive politically than the opposition parties' proposal to abolish it outright. The LDP's plan would eliminate the tax on food at the retail stage and reduce it to 1.5 percent at the farm and the wholesale levels (see JEI Report No. 46B, December 8, 1989).

In any event, Mr. Kaifu will not have much time to ruminate over the soundness of his decision to go to Europe. Immediately after his January 18 return to Tokyo, the prime minister had to hit the ground running to orchestrate enactment of the FY 1989 supplemental budget. From the end of January, when he is expected to dissolve the lower house, through February 17 Mr. Kaifu probably will face the rigors of the campaign trail, a time when he will learn firsthand how the populace would like Japan to be ruled.

Barbara Wanner

Tokyo Expected To Extend Car Export Limits

Strictly political. That is the only way to describe Tokyo's decision in early 1988 and again at the start of 1989 to keep Japan's U.S.-bound car exports capped at 2.3 million units a year. All of the economic factors weighed by Ministry of International Trade and Industry policymakers in early 1988 and again at the start of 1989 pointed to the opposite move -- an end to managed trade in cars. Admittedly, 1987 and 1988 sales of cars built in North America by General Motors Corp., Ford Motor Co. and Chrysler Corp. were below the figure for 1985, the industry's best year in the 1980s, but they were considered fairly robust given the number of vehicles that had been sold in the American market since 1982. Support for this judgment was no farther away than the Big Three's record-shattering 1988 profits and 1987's near miss, including significant profits in both years from U.S. automotive operations.

Japan's export figures were additional proof that the shipment limit, in effect since April 1981, had become economically irrelevant. Exports came in 3.7 percent below the quota during the April 1987-March 1988 period; in the 12 months through March 1989 the shortfall was even larger -- 5.3 percent. Mirroring this cutback, U.S. sales of Japanese-made cars declined in 1987 from 1986's all-time high and fell again in 1988. Adding in the expanding volume of cars assembled in this country by Japanese automotive makers obviously changed the sales numbers and market share figures for Japanese nameplates (see Table 1) but not the conclusion that the economic rationale for restricted competition in cars had long since disappeared.

Exports are expected to fall at least 10 percent short of the cap in the current fiscal year. Shipments in the April-November 1989 period were running 13 percent below their scaled-back 1988 level, and with two-thirds of the restraint period already behind them, Japanese automotive producers had filled only 56 percent of the quota. Perhaps even more significantly, all nine exporters are said to be having trouble supplying their full allotment, not just Nissan Motor Co., Ltd., which accounted for most of the export shortfall in both FY 1987 and FY 1988.

In deciding last year to extend the shipment restraints through March 1990, MITI officials held out the possibility that the export ceiling would be

Table 1: U.S. Retail Car Sales, 1983-89

(units)

Manufacturer/Seller	1983	1984	1985	1986	1987	1988	1989
Japanese Imports							
Toyota Motor Corp. (incl. Lexus)	555,766	557,981	620,047	633,914	583,809	616,529	511,271
Nissan Motor Co., Ltd. (incl. Infinity)	521,902	485,298	535,372	494,294	409,476	360,745	406,870
Honda Motor Co., Ltd. (incl. Acura)	350,670	374,819	406,413	458,268	421,688	393,360	393,630
Mazda Motor Corp.	173,388	169,666	211,093	222,676	206,354	224,719	221,794
Fuji Heavy Industries, Ltd. (Subaru)	156,840	157,385	178,175	179,100	175,864	155,946	136,112
Mitsubishi Motors Corp.	32,755	39,104	49,734	49,436	67,954	69,975	79,751
Isuzu Motors Ltd.	20,731	17,233	26,953	38,910	39,587	24,520	16,296
Daihatsu Motor Co., Ltd.	0	0	0	0	0	11,460	15,118
Suzuki Motor Co., Ltd.	0	0	0	0	0	524	6,009
Mitsubishi Motors Corp./Chrysler Corp.	103,569	91,718	105,213	135,528	120,337	113,800	98,324
Isuzu Motors Ltd./General Motors Corp.	0	2,077	53,593	99,380	76,852	68,347	62,232
Suzuki Motor Co., Ltd./General Motors Corp.	0	10,927	31,267	60,983	60,359	48,088	53,437
Domestic Makes							
General Motors Corp.*	4,053,561	4,587,508	4,607,458	4,532,798	3,555,538	3,641,542	3,276,941
Ford Motor Co.**	1,571,321	1,979,317	2,070,392	2,066,507	2,019,783	2,205,336	2,099,773
Chrysler Corp.***	841,622	986,998	1,139,936	1,173,463	962,057	1,062,782	917,506
American Motors Corp.	193,351	190,255	123,449	72,848			
Volkswagen of America Inc.	85,045	73,838	77,535	73,912	61,064	24,939	0
Honda of America Manufacturing, Inc.	50,402	133,601	145,976	235,247	316,618	375,625	389,472
New United Motor Manufacturing Inc./ General Motors Corp.	0	0	35,594	170,507	134,956	96,868	89,875
New United Motor Manufacturing Inc./ Toyota Motor Sales USA Inc.	0	0	0	7,281	44,853	57,637	****
Nissan Motor Manufacturing Corp. U.S.A.	0	0	39,794	52,602	119,678	112,125	103,134
Mazda Motor Manufacturing (USA) Corp./ Mazda Motor of America, Inc.	0	0	0	0	1,671	31,331	41,584
Mazda Motor Manufacturing (USA) Corp./ Ford Motor Co.	0	0	0	0	0	77,763	133,650
Toyota Motor Manufacturing, U.S.A., Inc.	0	0	0	0	0	14,717	****
Diamond-Star Motors Corp./ Mitsubishi Motor Sales of America, Inc.	0	0	0	0	0	0	32,018
Diamond-Star Motors Corp./ Chrysler Corp.	0	0	0	0	0	0	28,243
Domestic Makes Built by Big Three	6,659,855	7,744,078	7,905,641	7,675,109	6,402,422	6,735,029	6,042,452
Domestic Makes Built by Japanese Affiliates	50,402	133,601	221,364	465,637	617,776	766,066	1,030,364
Total Japanese Imports	1,915,621	1,906,208	2,217,860	2,372,489	2,162,280	2,088,013	2,000,844
Total Imports	2,385,734	2,441,713	2,841,063	3,239,043	3,144,048	3,065,073	2,794,598
Total Domestic Makes	6,795,302	7,951,517	8,204,721	8,214,662	7,081,262	7,526,034	7,072,816
Total Market	9,181,036	10,393,230	11,041,784	11,453,705	10,225,310	10,591,107	9,867,414
Market Share of Japanese Imports	20.9%	18.3%	20.1%	20.7%	21.2%	19.7%	20.3%
Market Share of Japanese Imports and Domestic Makes Built by Japanese Affiliates	21.4%	19.6%	22.1%	24.8%	27.2%	26.9%	30.7%

*Starting in 1985 includes the Geo Nova/Prizm made by New United Motor Manufacturing Inc.

**Starting in 1988 includes the Ford Probe made by Mazda Motor Manufacturing (USA) Corp.

***Starting in 1989 includes the Plymouth Laser and the Eagle Talon made by Diamond-Star Motors Corp.

****Combined sales were 212,388 units.

Source: Automotive News

lifted before then if deliveries declined over a sustained period (see JEI Report No. 3B, January 20, 1989). That precondition was met some time ago, but the ministry is even less inclined to end the limits this year than it was a year ago. The reason is simple: rapidly changing conditions in the U.S. car market have added an economic dimension to what had been a strictly political issue.

Despite the almost nonstop use of incentives, sales of cars assembled in North America by the Big Three tumbled 10.3 percent in 1989 to 6 million units, the industry's worst performance since the recession year of 1982. Sales of imported Japanese nameplates also fell last year, but that 3.8 percent drop to under 1.9 million cars was small consolation to GM, Ford and Chrysler, which are expected to report losses on their U.S. automotive operations for 1989's second half and possibly for the full year despite remaining profitable overall. For one thing, the American marketing units of Japanese motor vehicle makers retailed almost 2.6 million domestically built and imported cars, 4.7 percent more than 1988's then-peak tally; in the process they won a record 26 percent of total U.S. sales, up from the 23.1 percent market share gained the year before. To boot, the Honda Accord was the best-selling car in the United States in 1989, the first time a Japanese-designed model took top honors.

Although overall U.S. car demand was soft in 1989, the market did not experience the downturn that a number of industry forecasters had predicted. This year, however, could be a different story, judging by its rocky start. All three American automotive companies have announced temporary closings for most of their U.S. and Canadian plants during the first quarter and slower line speeds at the ones still operating in an effort to slice bulging inventories of unsold cars. The eight Japanese-affiliated assembly plants in the United States are not immune to the sales slowdown, but reports of widespread layoffs in Big Three plants are creating difficult public relations problems for the transplants. Previously polite talk in the industry about these factories "displacing" sales by Detroit is being replaced by charges of "stealing" as the transplants expand their output and GM, Ford and Chrysler trim their operations (see Table 2).

Given the pessimistic projections for Big Three car sales in 1990, U.S. industry executives and automotive-state representatives on Capitol Hill have been surprisingly quiet about Japan's export restraints after March. Only the United Auto Workers union has pressed MITI to extend the quota for another year and it did that in mid-December with a minimum of publicity. This low profile has at least one obvious explanation: everyone concerned assumes that MITI will keep the restraints in place since abandoning them now would add fuel to the protectionist fires in the United States while not changing U.S. market opportunities for Japanese exporters.

This reasoning was on target. At JEI press time MITI Minister Hikaru Matsunaga disclosed that the export restraints would be kept in place for a tenth year. The January 17 announcement was a replay of 1989's. Saying that the government wanted to make sure exports were on the downswing before it removed the cap, Mr. Matsunaga added that the restrictions could be eliminated sooner than March 1991 if shipments continued to drop. The reaction at home and abroad also had a familar ring. GM and Chrysler spokemen dismissed the extension as a symbolic gesture, while Ford executives welcomed it. Japanese exporters also were divided, with some resigned to continued restraints and others expressing disappointment, at least for the record.

Table 2: U.S. Car Production (Commercial), 1987-89

(units)

	1987	1988	Estimated 1989	1990 Car Capacity
Honda of America Manufacturing, Inc. (Marysville, OH)	324,064	366,355	361,660	360,000
Honda of America Manufacturing, Inc. (East Liberty, OH)	0	0	0	65,000
New United Motor Manufacturing Inc. (Fremont, CA)	187,378	128,430	192,525	250,000
Nissan Motor Manufacturing Corp. U.S.A. (Smyrna, TN)	117,334	109,897	115,584	130,000*
Mazda Motor Manufacturing (USA) Corp. (Flat Rock, MI)	4,200	163,289	205,141	240,000
Toyota Motor Manufacturing, U.S.A., Inc. (Georgetown, KY)	0	18,527	151,122	200,000
Diamond-Star Motors Corp. (Normal, IL)	0	0	92,777	240,000
Subaru-Isuzu Automotive Inc. (Lafayette, IN)	0	0	6,029	60,000**
Total Japanese-Affiliated Plants	632,977	786,498	1,124,838	1,545,000
Volkswagen of America Inc.	66,696	35,997	0	
General Motors Corp.	3,455,463	3,427,276	3,100,162	
Ford Motor Co.	1,830,446	1,806,802	1,677,979	
Chrysler Corp.	1,109,411	1,072,845	915,103	
Total U.S. Output	7,094,993	7,129,420	6,818,081	
Japanese Share	8.9%	11.0%	16.5%	

*Plant's total capacity is 265,000 units a year, divided about equally between cars and compact pickup trucks.

**Plant's total capacity is 120,000 units a year, divided about equally between cars and compact pickup trucks.

Source: Automotive News

Susan MacKnight

Notes

Japan-China - The January 10 end of seven months of martial law in Beijing was greeted cautiously in Tokyo and Washington by government officials and businessmen alike. The Bush administration and the cabinet of Prime Minister Toshiki Kaifu welcomed the change but insisted that Beijing must take more substantive steps toward economic and political reform before relations return to

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JEI

REPORT

A Two-Part Report: A and B

NO. 4A January 26, 1990

JAPAN'S PRICE STRUCTURE

Summary

When a New Yorker visits Tokyo, whether on business or for pleasure, he begins to feel that every charge -- from dining to taxis -- is more expensive than at home. Similarly, increasing numbers of Japanese tourists confess that most products and services cost less in this country than in Japan. Although price differences between the two countries depend on what is bought and where, the hard fact is that the prices of many goods and services are relatively higher in Japan than in the United States. During the Structural Impediments Initiative talks American officials have cited Japan's pricing system as a nontariff barrier that limits exports to the world's second-largest economy.

Since a country's price structure is affected by many factors, such as its natural resources endowment, government regulations, business practices and consumer behavior, the best way to analyze it is to divide the economy into four sectors: public services, regulated services, regulated imports and tradable goods. In Japan a scarcity of natural resources is among the factors that help push up prices of public services. Excessive regulations make price competition difficult in Japan's service sector. Import restrictions boost retail prices for beef, oranges and rice. Moreover, the prices of tradable goods in Japan are higher than they otherwise might be because of corporate pricing strategies and the distribution network. Finally, a cultural emphasis on gift-giving and the business community's huge entertainment expenses exacerbate the situation.

Japan Economic Institute 1000 Connecticut Avenue, N.W., Washington, D.C. 20036 202·296·5633

High Prices in Japan

Various reports catalog the high cost of living in Japan. The Organization for Economic Cooperation and Development gives an analysis based on direct observation and purchasing power parity, the most commonly used basis for comparing prices around the world. Before the September 1985 Plaza Accord realigned major international currencies, Japan's purchasing power parity of Y218 was not that much different from the Y239=$1.00 exchange rate. In 1988, however, purchasing power parity indicated that Y201 was needed to buy $1 worth of goods, yet the average exchange rate for the year was Y128=$1.00. On this basis, at least, prices in Japan were 57 percent higher than in the United States.

The Economic Planning Agency's November 1988 international comparison of the prices of various products and services gives more direct information. EPA's investigation revealed that the relative price of food in New York City was 69, setting Tokyo prices equal to 100 at the average 1988 exchange rate of Y128.15=$1.00. New York City durable goods rated a 76, clothing and footwear 67, utilities and water 44, transportation and communications 70 and rental housing 54. The average New York City price level was 72, which implies that Tokyo prices were 38.9 percent higher. Only medical services and education cost less in Tokyo (see Table 1).

Table 1: Relative Prices in New York and Hamburg, West Germany, November 1988

(Tokyo = 100)

	New York	Hamburg
Average	72	68
Food	69	64
Durable Goods	76	88
Clothing and Footwear	67	71
Other Products	79	89
Utilities and Water	44	70
Transportation	70	93
Health Care	106	24
Education	108	52
Rental Housing	54	51
Other Services	118	78

Source: Economic Planning Agency, Price Report 1989.

An October 1989 report by a Japanese business organization revealed the same facts. The Japan Committee for Economic Development (Keizai Doyukai) study compared the prices of frequently purchased products in Tokyo to those in New York City, London and other major foreign cities. Nineteen of the 39 products

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investigated cost more in Tokyo; in particular, 17 food items were 30 percent costlier than in New York City or Los Angeles.

Surveys by major newspapers and business magazines have found the same results, as has a recent widely publicized joint survey by the Ministry of International Trade and Industry and the Department of Commerce (to be discussed in detail below). There is no doubt that the prices for many goods are higher in Japan, particularly in Tokyo, than in other industrial countries. No one reason, however, explains the gap across-the-board.

Public Services

In the case of public services, among the main causes of high prices are the need to borrow large amounts of money, strict environmental regulations and, as in other countries, limited competition. Here are some examples:

- Utilities - The need to raise large amounts of funds in addition to the use of depreciation and retained earnings significantly affect electricity charges. According to EPA's November 1988 pricing study, electricity prices in Japan, based on Tokyo Electric Power Co., Inc. rates, came to Y20.33 ($0.145 at Y140=$1.00) per kilowatt-hour, 40.4 percent higher than the equivalent Y14.48 ($0.103) charged by New York's Consolidated Edison Co. Depreciation and interest charges accounted for 32 percent of TEPCO's total costs in contrast to 10 percent for ConEd. These costs are necessary to meet the increasing demand for electricity in Japan and the country's strict environmental and safety regulations for power plants. Moreover, TEPCO's average fuel costs -- Y5.25 ($.038) per kwh -- were 54 percent higher than ConEd's, according to the EPA study. This cost of inputs is a key component of Japan's high-cost structure.

For much the same reasons that electricity costs more in Japan than here, Japanese prices for natural gas are almost double those in America. In addition, though, Japanese suppliers have to bear an incremental charge for importing liquefied natural gas by ship and converting it back to natural gas for home and industrial use. Furthermore, since the ratio of business-related use to total gas consumption (19.8 percent) and average gas sales per consumer (7.6 million calories per year) are much smaller than in the United States (25.7 percent and 27.5 million calories, respectively), economies of scale are difficult to fully achieve.

- Telecommunications - After Nippon Telegraph and Telephone Public Corp. was privatized and the domestic telecommunications market deregulated in April 1985, telephone charges in Japan fell (see JEI Report No. 46A, December 8, 1989). Yet a price gap between there and the United States still exists for long-distance calls. A comparison of basic home service in both countries shows that local calls in Tokyo -- Y10 ($.07) for a three-minute call -- cost a little bit less than in New York -- Y12 ($.08) for an unlimited call. However, a long-distance caller in Japan pays Y330 ($2.36) for a three-minute, 200-mile call, while a similar long-distance call made from New York City might cost about Y112 ($.80). This gap can be traced back to the Ministry of Posts and Telecommunications and how it sets rates for NTT and, by extension, for NTT's three competitors in the domestic long-distance market.

Service Sector

During the 1980s the most frequently heard economic catchphrase in Japan was deregulation. In response to recommendations by an advisory panel on administrative reform established in 1980, the Japanese government deregulated the domestic telecommunications market and privatized NTT, reorganized the Japanese National Railways into eight separate private corporations and allowed more competition in the domestic and the international air travel markets. In spite of these actions Japan still has been named "The Kingdom of Regulation" by Professor Toshimasa Tsuruta of Senshu University. A recent study, titled "Reviewing Governmental Regulations from the Standpoint of Competition Policy," done by a Fair Trade Commission group chaired by Mr. Tsuruta, described various government regulations that protect service industries.

This study used 1985 input-output tables as a basis of calculating the ratio of value added in a government-regulated sector to the value added by each industry. It then added the regulated share of each sector to achieve an overall sum of 40.8 percent of the overall economy in 1988. Of the regulated industries, 59.1 percent -- or 24.1 percent of the whole economy -- was considered strongly regulated because of entry barriers or price controls. Mining, construction, finance and electric and gas utilities are completely regulated, according to this study's calculations. Furthermore, 95.3 percent of transportation and communications, 85.8 percent of agriculture, forestry and fisheries and 58.4 percent of other service industries, such as wholesale and retail trade, are regulated. In contrast, 16.8 percent of manufacturing and 3.6 percent of real estate received this designation (see Table 2).

Table 2: Role of Regulated Sector in Japan's Economy, 1988

(percent of gross national product)

Industry	Value Added Contribution to GNP	Share of Regulated Sector	Share of Strongly Regulated Sector
Agriculture, Forestry and Fisheries	3.0%	2.6%	1.7%
Mining	0.3	0.3	0.2
Construction	7.2	7.2	0.0
Manufacturing	28.0	4.7	2.8
Wholesale and Retail Trade	12.4	n.a.	n.a.
Banking and Insurance	5.5	5.5	5.5
Real Estate	9.5	0.3	0.3
Transportation and Communications	6.5	6.2	5.9
Electricity and Gas	2.9	2.9	2.9
Services	20.5	11.2	4.9
Public Sector	3.6	0.0	0.0
Other	0.7	0.0	0.0
Total	100.0	40.8	24.1

Source: Fair Trade Commission, "Reviewing Governmental Regulation from Standpoint of Competition Policy," 1989.

The official explanation for the regulations is that they secure "fair" competition. On paper they are designed to benefit consumers. In reality, though, the regulations protect established business interests by restricting competition.

Examples of regulatory overkill abound. A bus company must notify the central government about its office locations, parking spaces and the stops on each route as well as the number of buses, carrying capacities and the timetables of each operation; the firm also must submit an application to Tokyo whenever it wants to change the location of a stop in a rural area 500 miles away from Tokyo or on the island of Okinawa. A taxi operator must be in a specific age range and have a number of years of experience in this industry.

The government cites a need to match supply with forecasted demand as its reason for regulating entry to the trucking, bus, taxi and airline businesses plus liquor sales, banking and securities. Furthermore, new competitors must coordinate with existing local operators in the trucking business, liquor sales and big retail stores (see JEI Report No. 43A, November 10, 1989) before they can set up shop. Property insurers need 26 permits. Although interest rates on certain instruments over Y10 million ($71,429) were deregulated in 1988, interest rates on many types of deposits still are regulated by the Ministry of Finance. These and similar types of regulations stifle competition, delay innovation, paralyze the market mechanism and thus result in high prices.

Another reflection of the service industry's overprotection is its relatively low labor productivity. Setting 1985 U.S. productivity rates at 100, relative productivity in Japan was 80.9 in wholesale and retail trade, 57.5 in transportation and communications and 90.6 in other services. Service industries also recorded lower rates of productivity growth compared to manufacturing from 1975 to 1985. Over this period output per worker in the manufacturing sector jumped 95.8 percent. In services, though, the comparable figures were 41 percent for the electricity, gas and water industry, 57.9 percent for wholesale and retail trade, 28 percent for transportation and communications businesses, 26.6 percent in the finance field and 15.3 percent for other services.

Import Restrictions

As in other countries, protection from import competition in Japan takes the form of border measures -- tariffs, quotas, variable levies and state trading -- and budgetary and other direct subsidy programs, such as price supports. To determine the impact of exchange rate changes between 1985 and 1988 on domestic wholesale prices, the Economic Planning Agency last year compared the prices of 14 protected items -- powdered milk, sugar, cheese, wheat, beef, pork, leaf tobacco, cigarettes, whiskey, wine, brandy, silk, steam coal and coking coal -- to those of 66 unrestricted products. EPA's study indicated that wholesale prices for the 14 products remained unchanged through the 1985-88 period despite a 25 to 30 percent reduction in import prices. Conversely, wholesale prices for the unregulated products fell about 20 percent in parallel with a reduction of about 25 percent in import prices. For agricultural goods these results imply that agricultural import restrictions are one of the main causes of the high price of food in Japan.

A study published by the Bank of Japan in December contained similar results. BOJ examined 13 of the 14 regulated products (cigarettes were the exception) investigated by EPA, calculating wholesale and import prices in July 1989. Using 1985 as 100, average import prices on the regulated items declined to 70.6 but average wholesale prices rose to 102.8. Through the same period wholesale prices for the surveyed unregulated products -- such as cement, steel, nonferrous metals, cotton and electrical goods -- declined and lowered the overall wholesale price index by 2 percent. BOJ's report, which said regulated products make up 18 percent of the WPI and 28 percent of the consumer price index, indicated that average wholesale prices could be reduced 3 percent if all import restrictions, including the sole-agent import system and administrative guidance on home kerosene prices, were removed.

Tradable and Deregulated Products

A price study of 20 foreign brand name products (handbags, perfume, whiskey and brandy) done by the Tokyo metropolitan government last August, found 14 were priced higher in Tokyo than in other major cities, such as London, Paris, Milan and Hong Kong. The study also found that Japanese retail prices for the imported products were three to seven times higher than the landed prices of the foreign merchandise. This meant that the import price accounted for only 15 percent of the final cost for French-made perfume, 20 to 25 percent for Scotch and bourbon whiskey and 31 percent for French- or Italian-made handbags. These results suggest not only that distribution margins in Japan may in some instances be large but that substantial price differentials may exist for tradable products between Japan and its foreign suppliers.

The Ministry of International Trade and Industry and the Department of Commerce carried out the most extensive study yet on the price differences among tradable goods in October 1989. The results were released in conjunction with the second round of the Structural Impediments Initiative talks in November. Surveying the prices of 122 products in New York City, Chicago, Tokyo and Osaka and using Y142=$1.00 as the exchange rate, investigators found that 84 of the items were more expensive in Japan than in the United States while the reverse was true for 38 goods -- a 2-to-1 ratio. The sampled products included 23 made in Europe; of these 22 sold for more in Japan than in the United States. This implies that the distribution system is the main reason for the higher prices of European goods in Japan. The sole-agent import system and the prestige of European makers, which lets distributors mark up prices, contribute to the problem in Japan, where brand name products, such as Gucci, Yves Saint Laurent and Burberry, find a comfortable niche in a huge gift market.

The causes of the pricing differentials for the surveyed American- and Japanese-made products are not as clear-cut. In early November testimony before the Senate Finance Committee's subcommittee on international trade, Robert Lawrence, senior fellow at the Brookings Institution, said his analysis of distribution margins indicated that Japanese manufacturers, not distributors, are responsible for Japan's high prices. He noted as well that Japanese export and domestic prices vary. This suggests that Japanese producers engage in price discrimination, maintaining prices at home higher than elsewhere.

In the MITI-DOC price study 50 of the 122 products surveyed were made in Japan (see Table 3). Of these 21 (42 percent) were priced higher in Japan than in the United States. That leaves 29 of the Japanese-manufactured products (58 percent) selling for less in Japan. Therefore, the study shows that not every manufactured good is relatively more expensive in Japan. However, of the 35 products made in America and included in the study, 31 (88.6 percent) were cheaper in this country than in Japan. The big difference between this figure

Table 3: Japan-U.S. Retail Price Comparisons, 1989

(number of products)

	Made in Japan	Price Higher in Japan	Made in United States	Price Higher in United States
Cars	2	1	2	0
Automotive Parts	4	3	1	0
Consumer Electronics	27	9	3	1
Food Products	4	3	10	0
Miscellaneous Consumer Goods	2	0	15	2
Scientific and Medical Equipment	11	5	4	1
Total	50	21	35	4

Notes: Study conducted in New York City, Chicago, Tokyo and Osaka. An exchange rate of Y142=$1.00 was used. The following products were surveyed:

Automotive parts - tires and spark plugs.

Consumer electronics - electric shavers, cameras, camera lens, film, calculators, laser printers, microwave ovens, video cameras, videocassette recorders, portable compact disk players, audio tape, cordless telephones and batteries.

Food products - ketchup, breakfast cereals, jam and chocolate.

Miscellaneous consumer goods - beer, wine, sake, whiskey, cigarettes, bed linens, men's blue jeans, china tea cups and saucers, fragrances, golf balls, golf clubs, stationery, pens, eye drops and movie tickets.

Scientific and medical equipment - dental casting machines, porcelain dental furnaces, digital storage oscilloscopes, spectrophotometer and liquid chromatograph.

Source: Department of Commerce and Ministry of International Trade and Industry, November 1989.

and the comparable number of 58 percent for Japan implies that more forces are at work in Japan pushing up prices.

Several possibilities might explain the difference. Mr. Lawrence has hypothesized that widespread adherence in Japan to manufacturers' suggested retail prices is responsible. Others blame the discriminatory pricing (dumping) strategy of Japanese exporters interested in gaining market share abroad. Others cite the slowness of exporters to increase prices on U.S.-bound exports in response to the weaker dollar. Other structural factors, such as Japan's fairly steep corporate taxes, the high cost of land and the distribution system, each have their advocates.

It is unlikely that dumping explains the overall price differential; in any case, dumping calculations are not based on retail prices. Slow adjustment to exchange rate changes also cannot be an across-the-board answer because 14 months already have passed since the dollar recorded its lowest level of Y120 in November 1988. Some structural factors, such as high land prices in Tokyo or the multilayered distribution system, certainly have inflated Japanese prices. Yet it is hard to believe that Japan's higher prices are caused solely by them.

As far as manufacturers having a strong hand in retail price-setting, there are some reports of episodes in which a Japanese manufacturer threatened retaliation against a deep discounter, a factor considered by some to have a significant influence on price determination at the retail level. However, these reports are supplied by newspapers as anecdotal evidence and lack an objective estimate of how manufacturers have affected retail pricing.

Even if manufacturers in Japan are able to exert more influence on retail prices than their American counterparts, this development has limited explanatory power for the high domestic prices. In Japan's consumer price index products supplied by big businesses account for only 19.4 percent by weight of the goods and services making up the index -- higher than the 11.5 percent for agricultural products but a little bit less than the 20.6 percent for the output of small producers and much less than the 42 percent assigned to services. Therefore, the high prices of certain manufactured goods can be reduced to some extent by removing the influence of manufacturers on retail price-setting, but that still would not do much to lower the overall price level in Japan.

Other Structural Factors

Consumer Behavior - An abundance of anecdotal evidence shows the irrational behavior of many Japanese consumers. When a well-known Japanese department store, for example, decided to sell foreign-brand goods at a discount, sales plunged. On the next day, when the store relabeled the merchandise and doubled the price, all the goods on the shelves sold that day. Many analysts suggest that Japanese consumers themselves are responsible for the high prices of some products. In such cases, consumers with discriminating taste apparently lack discrimination in pricing.

Gift Market - Japan has a huge gift market based on traditions in both personal and business relationships. A gift is regarded as an honorarium-in-kind for business clients, persons of senior status and go-betweens in arranged marriages. The price of a gift usually is considered much more important than the kind of gift. A year ago a prestigious Y5,000 ($36) bottle of whiskey made by Japanese distillers was a typical gift. However, once the price was decreased 25 percent in response to cuts in Japan's liquor taxes, gift sales of this whiskey slipped, and demand shifted to a more "prestigious" whiskey, which was newly priced at Y5,000. The Japan Economic Journal estimates that Japan's gift market now is valued at Y12.7 trillion ($90.7 billion), larger than the Y10 trillion ($71.4 billion) in total sales by department stores. The gift market is expected to expand to Y20 trillion ($142.9 billion) in five years.

Corporate Consumption - Since personal, long-term relations are considered a key to business success in Japan, substantial corporate entertainment expenses, even though they are taxed completely for large corporations, are necessary, an indication of sincerity toward the business client. To invite clients to an expensive weekend golf outing or gourmet dinner at a cozy Japanese or French restaurant are two of the most popular types of corporate entertainment. Similar to the gift, the higher the cost, the higher the esteem. This allows clients and companies to judge how eager each is to do business.

Japanese tax authorities revealed that total entertainment costs reached nearly Y4.6 trillion ($32.5 billion) in 1988, an increase of 8.3 percent. This figure is said to be almost three times higher than in the United States and 14 times greater than the number for Great Britain. Corporate consumption increases prices in two ways: the ripple effects caused by a business paying high prices for costly products and the higher charges for its product or service to cover the huge expenditures needed for entertainment.

Other Factors - For some products fixed retail sales prices are set legally. This action does not violate antitrust law in Japan under a provision called the resale price maintenance contract, which has no U.S. counterpart. The covered products include 2,417 cosmetics and 201 pharmaceutical products, books, magazines, newspapers and records. The purpose of this contract is said to be to prohibit companies from predatory pricing of goods that are copyrighted or have a close relation to health. However, such relatively new products as videotapes, cassette tapes, compact disks and computer programs are not subject to this contract despite the fact that they have the same type of copyright protection. Therefore, it does not make any economic sense for only books and the other items listed to be protected from the standpoint of fair competition. Rather, historical factors have tended to keep the monopolistic interests alive.

Japanese retail stores have been accused of tending to avoid competition on the basis of prices by tacitly agreeing with neighboring stores to set a uniform price. A recent reported example is that of a major discount chain selling cameras and videocassette recorders that was forced by small local retail stores to promise not to reduce the price of a new camera when it opened an outlet in a popular shopping area of Shibuya in Tokyo. The end result is that the small retail stores continue in business while the discount store accrues bigger profits by raising its normal prices. The consumer loses most. This situation has led consumer activitists and others to call for strengthened implementation of Japan's antimonopoly law.

The Japanese distribution system with its multilayered structure, product-return option, sole-agent import system and large-scale retail store law also has affected and sustained high prices in Japan (see JEI Report No. 43A, November 12, 1989). High land prices are also a key factor boosting prices, in particular in Tokyo (see JEI Report No. 39B, October 13, 1989).

Conclusion

Japanese prices are high for a variety of historical reasons, none of which apply as a single explanation common to all products. However, based on an analysis by sector, it is possible to make some proposals that could reduce prices in each. Extensive borrowing requirements, scarce resources and, in some instances, limited economies of scale are the main reasons for the high prices of public services. Therefore, to reduce prices, industries in this category should seek ways of conserving on capital expenditures, finding inexpensive alternative natural resources and achieving production efficiencies. Competition, too, could reduce prices, as long as the industries meet public expectations for stable supplies.

Concerning the service sector and imports, high prices appear to be the direct result of excessive government regulations. Therefore, deregulation could help to decrease prices. It will be just a matter of time before discussions begin on whether current regulations should be maintained or how fast they can be altered.

Even in deregulated industries, there is evidence implying that stronger implementation of the antimonopoly law or efforts to promote competition are effective ways to lower the tags of some pricey manufactured goods. High land prices and other structural factors also appear to keep prices high. Their impact, too, could be lessened to some extent by deregulation because they are historical products of past governmental regulations. Therefore, the key to altering Japan's high price structure lies in how fast the government deregulates the economy and allows the market to arbitrate prices.

For further information, contact Hideo Takahashi.

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The views expressed in this report are those of the author and do not necessarily represent those of the Japan Economic Institute.

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JEI

REPORT

A Two-Part Report: A and B

NO. 4B
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IN THIS ISSUE:

Financial Markets Tumble In Tokyo 1

Mergers In Japan Rise 4

Tighter Labor Market
Worries Wage Negotiators 5

Diplomacy Continues On Northern Territories 7

Japan's Ex-Im Bank Contemplating
Lending To U.S. States 9

Notes: Joint Industrial Cooperation
Initiative 10

Financial Markets Tumble In Tokyo

For those who seem to live and die by the direction of a line on a chart, the news was disheartening, to say the least. The lines describing bond and stock markets in Japan and the value of the yen took uncharacteristically simultaneous turns downward during the first three weeks of 1990. While each market individually has had periods of weakness in recent months, many analysts thought the triple retreat an odd way to begin a decade in which many experts say Japan will solidify the economic gains made in previous years and emerge as an ever more important player in the global economy.

Subsequent events provided fresh evidence that Japan's financial clout already is considerable. Worried traders in the United States and Europe, fearful that something was amiss in Tokyo, pushed down prices on financial markets in New York and elsewhere. Did the latest Tokyo downturn provide evidence that Japan's economic juggernaut had run out of steam?

Mergers In Japan Rise

Domestic mergers and acquisitions have risen for three straight years in Japan notwithstanding the popular sentiment that conducting a merger or acquisition there is more difficult than in the United States or Europe. Rapidly growing Japanese M&A activities overseas combined with increasing criticism of Japan's merger market are causing gradual changes in Japanese attitudes toward the buying and selling of companies.

According to data collected by Yamaichi Securities Co., Ltd., the total number of mergers and acquisitions announced by Japanese firms rose 19.1 percent in 1989 to 661 (see Table). Leading the way were Japanese purchases of foreign firms, rising from 315 in 1988 to 404 last year, up 28.3 percent. Mergers and acquisitions between Japanese firms rose 7.6 percent, from 223 to 240, while foreign purchases of Japanese companies fell from 19 to 17.

Japanese Merger and Acquisition Announcements, 1984-89

(number of announced transactions)

	1984	1985	1986	1987	1988	1989
Japanese Purchases of Japanese Firms	140	163	226	219	223	240
Japanese Purchases of Foreign Firms	44	100	204	228	315	404
Foreign Purchases of Japanese Firms	6	26	21	22	19	17
Total	190	289	451	469	557	661

Source: Yamaichi Securities Co., Ltd.

Figures compiled on a different basis by Japan's Fair Trade Commission show a similar trend, with the number of mergers among domestic firms rising from 1,223 in fiscal 1987 to 1,336 in the year ending March 31, 1989. While the FTC's annual report to the Diet attributed much of the activity to restructuring by Japanese corporations, diversification into new fields backed by strong profits aided the growth of mergers.

The upturn in domestic M&A activity reflects a significant change in Japanese business attitudes. A survey released last October by an advisory body of the Ministry of International Trade and Industry indicated that about 16 percent of the 1,000 firms contacted had launched a merger or acquisition bid within the last two years. Another 6 percent were considering such a move. Of those that attempted a merger, 76 percent viewed it as a positive business strategy; 11.5 percent of this same group said they would attempt another bid under any circumstances, and an additional 58.6 percent said they would be willing to take the risk if the deal made enough economic sense. The survey showed near unanimous rejection of M&A if the purpose of the bid is merely to make money. Such "insincere" bids still brand the participants as a "hijacker" or a "seller of one's body" (the literal translation of the traditional Japanese terms for takeover and divestiture).

Most Japanese mergers and acquisitions still are labeled as "friendly," even though a growing number of transactions initially are hostile. Indeed, only struggling Japanese firms welcome an unsolicited bid. A Japanese takeover bid remains a bilateral affair. Unlike the U.S. version, where brokers put a company "in play" hoping to attract several bids, in Japan it is still unheard of for two or more bidders to pursue a single target. Moreover, the emphasis in Japan is on mergers, not acquisitions, although the practical differences between the two are insignificant. Japanese M&A brokers therefore consider their role more akin to matchmaking than money-making. Nevertheless, the field is attracting both foreign and domestic firms, raising the level of competition and aggressiveness.

At the second session of the Structural Impediments Initiative talks in November, the U.S. side reportedly offered a multipoint plan to change many Japanese business practices that American government and industry officials feel impede M&A activity in Japan. Many of the ideas target the practice of cross-stockholding -- the placement of a majority of a firm's stock with friendly investors, often close business associates. Cross-stockholding makes it difficult, if not impossible, for a new investor to gain control of a takeover target. Other SII talking points addressed the decided Japanese bias against shareholder rights. As several recent cases show, the management of a Japanese firm can ignore the wishes of even the firm's largest shareholder. Koito Manufacturing Co., Ltd., for example, continues to rebuff overtures from T. Boone Pickens, despite his 20 percent-plus stake. And Chujitsuya Co., Ltd. and Inageya Co., Ltd. still are resisting efforts of top shareholder Shuwa Corp. to merge the two department store chains with two others.

The Japanese SII delegation reportedly did not respond to the American suggestions. Although it is too early to tell if the ongoing SII talks will yield any results in this area, the Ministry of Finance already has taken some steps to address complaints. MOF plans to drop prior notification requirements for takeover bids and extend the bid period from 30 days to 60 days. MOF claims that the new rules are very similar to U.S. rules. The new regulations would have a broader impact, however, since MOF also proposes to lower the threshhold at which the notification rules for stock purchases come into play from 10 percent to 5 percent of a firm's outstanding shares. Observers on both sides of the Pacific doubt that MOF's action will alleviate foreign pressures for changes in Japan's domestic M&A market, particularly since the market is heating up.

Jon Choy

Tighter Labor Market Worries Wage Negotiators

The current economic boom, which has benefited all Japanese industries over the past two years, now is producing a new concern for business executives as the season for wage negotiations approaches. With the tight labor markets brought about by economic expansion, labor unions feel quite confident of being able to win a considerable increase in monthly wages during the annual spring wage negotiations scheduled to start in early April. Business officials, however, are concerned that any wage hike higher than the growth in labor productivity will add to the costs of their products or services and thus end up

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REPORT

A Two-Part Report: A and B

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IN THIS ISSUE:

Kaifu Dissolves Lower House For February 18 Elections 1

Japan's Trade Surplus Falls For Third Year 4

Japan's Savings Rate Dips In 1988 7

Japanese Research Spending Rises 8

Foreign Direct Investment Debate Continues 11

Notes: Export Controls; 1989 Land Prices 12

Kaifu Dissolves Lower House For February 18 Elections

Prime Minister Toshiki Kaifu dissolved the House of Representatives January 24 and formally set February 18 as the day Japanese voters will go to the polls to select their lower house representatives. In a special cabinet meeting the government also set February 3 for candidate registration and the official start of the election season. The ruling Liberal Democratic Party's 34-year leadership of the Japanese government will be at stake in these elections due to its unprecedented losses to the noncommunist parties in the July House of Councillors elections. The LDP's failure to win at least a simple majority of 257 seats in the lower house contests would precipitate important changes in Japan's postwar political structure -- changes that probably would include formation of a LDP/opposition party coalition government as well as Mr. Kaifu's resignation.

In the traditional preelection "pep talk" following dissolution of the lower house, Mr. Kaifu called on his LDP colleagues to do their utmost to secure at least 257 seats. The ruling party currently holds 294 seats in the lower chamber, which means that the LDP controls all of the lower house committees important political decisions. It remains to be seen how this ostensible "backroom wheeling and dealing" -- precisely the style of politics to which voters reacted in the upper house elections -- plays back in the home districts.

Barbara Wanner

Japan's Trade Surplus Falls For Third Year

A year ago Japan's trade surplus looked intractable. The effect of the near doubling in the yen's value between 1985 and 1988 appeared to have run its course, with the imbalance stuck at a high, politically unsustainable level. Between July 1988 and March 1989 the dollar-denominated quarterly surplus actually increased in a year-to-year comparison. Japan's surplus with the United States also widened during 1988's last quarter and the first three months of 1989. The handwringers paid little attention to other, broader measures, such as the current account, that suggested the situation was a good deal murkier -- and more favorable to those hoping for a smaller imbalance -- than the trade figures suggested. During this period the so-called revisionist school gained influence with many U.S. opinion leaders, who argued that the then current trade figures indicated that Japan's economy did not respond to market signals the way American economists and political leaders had assumed it would.

A year later Japan's overall trade surplus is still large. However, most analysts admit that events in the last half of 1989 suggested at least some movement. For the year exports were up a scant 3.9 percent in dollars, while imports increased 12.5 percent by the same measure, resulting in a 16.9 percent decline in the imbalance for the year to $64.4 billion (see Tables). The drop would have been far greater if the first quarter of 1989 had not moved in the opposite direction.

Forces that had been at work all year gained strength during the final three months of the year. Dollar-denominated exports dropped 3.6 percent, the first year-to-year cutback since the first quarter of 1985. Imports in the quarter were up 14.5 percent. The result was a whopping 40 percent decline in the excess of exports over imports and the lowest fourth-quarter surplus on a dollar basis since 1984.

Do the fourth-quarter figures suggest that Japan's trade surplus might be a thing of the past within a couple of years? That would be an exaggeration. In part, the decline was a reaction to the abnormally large October-December 1988 surplus that so agitated the revisionists. In addition, the J-curve effect, which results from the opposite movements -- and differences in timing -- between the price and the volume effects of exchange rate changes, had an influence during the period. The yen was 11.5 percent weaker in the fourth quarter of 1989 than during the same period of 1988, implying that goods priced in yen appeared cheaper when expressed in dollars. As a result, dollar-denominated exports and imports were both smaller than otherwise in 1989, which tended to reduce the size of the imbalance.

Imports rose in part because oil prices, which were somewhat higher on average last year than in 1988, jumped in the fourth quarter of 1989. Of the 14.5 percent expansion in dollar-denominated imports in the fourth quarter, approximately one-third was accounted for by more expensive oil compared to the

Japan's Total Trade in Dollar Terms

(in millions of dollars)

	Exports (f.o.b.)	Change Over Year-Earlier Period	Imports (c.i.f.)	Change Over Year-Earlier Period	Trade Balance
1985	$175,638	3.2%	$129,539	-5.1%	$46,099
1986	209,151	19.1	126,408	-2.4	82,743
1987	229,221	9.6	149,515	18.3	79,706
1988	264,917	15.6	187,354	25.3	77,563
1989 (p)	275,173	3.9	210,739	12.5	64,434
1987: I	51,464	13.1	31,977	-3.1	19,487
II	56,931	7.1	36,380	15.8	20,551
III	57,855	5.6	38,346	27.2	19,509
IV	62,972	13.0	42,812	34.5	20,159
1988: I	60,279	17.1	44,505	39.2	15,774
II	65,179	14.5	47,260	29.9	17,919
III	67,169	16.1	47,258	23.2	19,911
IV	72,291	14.8	48,331	12.9	23,960
1989: I	68,247	13.2	51,147	14.9	17,100
II	67,632	3.8	51,272	8.5	16,360
III	69,605	3.6	53,005	12.2	16,600
IV (p)	69,690	-3.6	55,316	14.5	14,374

Japan's Total Trade in Yen Terms

(in billions of yen)

	Exports (f.o.b.)	Change Over Year-Earlier Period	Imports (c.i.f.)	Change Over Year-Earlier Period	Trade Balance
1985	Y41,956	4.0%	Y31,085	-3.8%	Y10,871
1986	35,290	-15.9	21,551	-30.7	13,739
1987	33,315	-5.6	21,737	0.9	11,578
1988	33,939	1.9	24,006	10.4	9,933
1989 (p)	37,822	11.4	28,963	20.6	8,858
1987: I	7,960	-8.2	4,959	-21.7	3,002
II	8,153	-10.6	5,207	-3.6	2,946
III	8,507	-1.5	5,644	18.6	2,864
IV	8,694	-1.9	5,928	17.2	2,767
1988: I	7,713	-3.1	5,688	14.7	2,025
II	8,163	0.1	5,918	13.6	2,246
III	8,924	4.9	6,280	11.3	2,644
IV	9,139	5.1	6,121	3.3	3,018
1989: I	8,707	12.9	6,516	14.6	2,191
II	9,226	13.0	6,994	18.2	2,232
III	9,912	11.1	7,541	20.1	2,371
IV (p)	9,977	9.2	7,912	29.3	2,065

Japan's Trade with the United States in Dollar Terms

(in millions of dollars)

	Exports (f.o.b.)	Change Over Year-Earlier Period	Imports (c.i.f.)	Change Over Year-Earlier Period	Trade Balance
1985	$65,278	8.9%	$25,793	-4.0%	$39,485
1986	80,456	23.3	29,054	12.6	51,401
1987	83,580	3.9	31,491	8.4	52,090
1988	89,634	7.2	42,037	33.5	47,597
1989 (p)	93,186	4.0	48,184	14.6	45,002
1987: I	18,001	7.8	6,986	11.3	11,015
II	21,181	1.2	7,592	-8.6	13,589
III	21,628	1.6	8,252	9.7	13,376
IV	22,770	5.6	8,660	24.7	14,110
1988: I	19,859	10.3	10,090	44.4	9,769
II	21,610	2.0	10,458	37.8	11,152
III	23,056	6.6	10,667	29.3	12,389
IV	25,109	10.3	10,821	25.0	14,288
1989: I	22,728	14.4	11,566	14.6	11,162
II	23,011	6.5	12,065	15.4	10,946
III	24,118	4.6	12,444	16.7	11,674
IV (p)	23,329	-7.1	12,109	11.9	11,220

Japan's Trade with the United States in Yen Terms

(in billions of yen)

	Exports (f.o.b.)	Change Over Year-Earlier Period	Imports (c.i.f.)	Change Over Year-Earlier Period	Trade Balance
1985	Y15,583	9.6%	Y6,213	-2.4%	Y9,369
1986	13,564	-13.0	4,918	-20.9	8,646
1987	12,148	-10.4	4,582	-6.8	7,566
1988	11,487	-5.4	5,388	17.6	6,099
1989 (p)	12,816	11.6	6,624	22.9	6,192
1987: I	2,786	-12.7	1,083	-9.9	1,703
II	3,034	-15.5	1,086	-23.6	1,948
III	3,180	-5.2	1,215	2.1	1,965
IV	3,148	-8.2	1,198	8.5	1,950
1988: I	2,541	-8.8	1,290	19.1	1,251
II	2,706	-10.8	1,309	20.5	1,397
III	3,063	-3.6	1,418	16.7	1,645
IV	3,177	0.9	1,371	14.4	1,806
1989: I	2,900	14.1	1,474	14.2	1,426
II	3,141	16.1	1,649	25.9	1,493
III	3,436	12.2	1,770	24.8	1,666
IV (p)	3,339	5.1	1,732	26.4	1,607

year-earlier period. However, Japan's trade surplus in both the fourth quarter and the year would have narrowed even in the absence of J-curve effects or oil price increases. Export volume for the September-December period was unchanged compared with a year earlier, while import volume jumped 8.9 percent. For the year exports in real terms grew 4.3 percent and the comparable import number increased 7.8 percent over 1988.

During 1989 changes in Japan's trade with the United States mirrored those with the rest of the world, although the trends were less pronounced. The bilateral surplus inched down to $45 billion, although it rose slightly in yen terms. During the fourth quarter, however, the decline in the surplus in both yen and dollar terms was dramatic, with the dollar measure showing a 21.5 percent contraction.

Some Japanese observers are troubled by the increasing percentage of Japan's surplus accounted for by the United States. The bilateral imbalance represented 61.4 percent of the total in 1988; in 1989 the figure rose to 69.8 percent. This reflects an analogous trend in the U.S. data that worries many U.S. policymakers: a rising percentage of the U.S. trade deficit is accounted for by Japan. In other words, the United States and Japan have made progress on their overall trade deficits and surpluses, respectively, but the bilateral imbalance appears to be relatively stubborn as measured by either country's data. Economists are virtually unanimous in believing that global imbalances are of far greater importance than bilateral ones and tend to dismiss such findings; politicians disagree. With the temperature of the political rhetoric determined by the bilateral imbalance, these data suggest that discussions between Washington and Tokyo will remain heated.

Douglas Ostrom

Japan's Savings Rate Dips In 1988

The Economic Planning Agency had a good news/bad news story in mid-January for those in Japan and abroad unhappy about Japan's high savings rate. The good news: savings in Japan, measured as a percentage of household disposable income, dipped to a 22-year low of 14.8 percent in 1988, down from 15.1 percent in 1987. During the mid-1970s the rate averaged above 20 percent before drifting downward in the 1980s. The bad news: even the lower 1988 figure was enough to keep Japan near the top among the 24 members of the Organization for Economic Cooperation and Development and well ahead of the United States, which registered a 4.2 percent rate in 1988, up from 3.2 percent in 1987.

In the current Structural Impediments Initiative talks both the United States and Japan have put savings rates on the short list of complaints about the other's economy. Tokyo feels that Americans undersave and Washington argues that the Japanese oversave. The latest figures suggest that, at least among households, savings rates converged ever so slightly in 1988.

EPA believes that Japan's household savings rate will continue declining, reaching 13 percent in 1993 and 11 percent by the turn of the century. Extrapolation of the rates for other industrial countries suggests that Japan's rate could dip below that of West Germany by the middle of this decade. In 1988 West Germany's household savings rate, which has been showing a steady increase since the mid-1980s, was 12.6 percent.

Households, of course, are only one source of savings. Business and government also save or dissave. For example, higher corporate profits and depreciation charges reduce the need for businesses to rely on household savings, other factors being equal. More comprehensive Japanese measures that account for savings outside the household sector are not available for 1988, but in 1987 overall savings came to 18.2 percent of gross national product. Of this, 56 percent, or an amount equivalent to 10.2 percent of GNP, came from households. These figures suggest that personal savings are an important, but not overwhelming, source of funds to finance domestic and foreign investment.

Japanese savings, including that by households, matter to Washington. Savings are a factor in financing the U.S. trade deficit; in the process these funds prop up the dollar by creating a demand for dollars and a supply of yen. Moreover, Washington fears that funds that stay in Japan could finance capacity expansion and lead to an export surge.

Various academic studies and common sense both suggest that, in Japan and elsewhere, savers and financial intermediaries prefer to invest their funds domestically, provided they can get competitive returns. Hence, most experts link high savings to high investment levels. During 1988 Japanese firms invested 17.5 percent of GNP in plant and equipment, far ahead of the U.S. rate of 10 percent. Investment spending, in turn, is one of the building blocks of greater productivity and economic growth. American policymakers, then, have an obvious interest in discovering the secrets of Japan's high savings rate in their search for ways to boost this country's economic performance. In Washington much of the talk has centered on the tax system as a way of inducing American households to save. As part of his budget for FY 1991 President Bush recently proposed new tax incentives to make Americans more inclined to save.

However, Professor Hiromitsu Ishi of Hitotsubashi University, in a recent study covering the period 1965 to 1986, failed to find a definite relationship between taxation and personal savings rates in Japan. Mr. Ishi argues that socioeconomic factors and economic growth are probably far more important than the tax system in explaining why Japanese households save so much. His analysis suggests that Tokyo has only limited ability to alter Japanese household savings behavior. Moreover, if Americans respond to the same economic incentives as the Japanese, his research is bad news for those in Washington hoping that a quick fix based on tax changes will lift American savings and investment levels closer to those of Japan.

Douglas Ostrom

Japanese Research Spending Rises

Japanese outlays for research and development continue to grow rapidly, spurred by economic restructuring and fear of losing international economic competitiveness due to the yen's strength against major currencies. While there is agreement that Japanese spending expanded at a healthy pace in fiscal 1988 and again in FY 1989, the outlook for the future is mixed. The current U.S. research spending picture, too, is mixed, leading observers to question the long-term impact of these spending trends on the bilateral and the overall trade balances of both countries.

According to a preliminary report by the Management and Coordination Agency, total Japanese research spending rose 8 percent in FY 1988 to just over Y10.6 trillion ($75.9 billion at Y140=$1.00), equivalent to 2.85 percent of that year's gross national product (see Table 1). Private companies accounted for the lion's share of the increase, recording an 11.2 percent hike to Y7.2 trillion ($51.6 billion). Struggling under the impact of an austere government fiscal policy, research spending by universities (Y2 trillion or $14.4 billion) and research laboratories (Y1.4 trillion or $10 billion) registered anemic gains.

Table 1: Japan's R&D Expenditures, FY 1984-FY 1988

(in billions of yen and percent)

Fiscal Year	Companies	Research Institutions	Universities	Total
1984	Y5,136.6	Y1,033.1	Y1,724.2	Y7,893.9
Change	12.6%	6.4%	4.5%	9.9%
Share	65.1%	13.1%	21.8%	100.0%
1985	5,939.9	1,160.6	1,789.8	8,890.3
Change	15.6%	12.3%	3.8%	12.6%
Share	66.8%	13.1%	20.1%	100.0%
1986	6,120.2	1,240.2	1,832.6	9,192.9
Change	3.0%	6.9%	2.4%	3.4%
Share	66.6%	13.5%	19.9%	100.0%
1987	6,494.3	1,384.5	1,957.9	9,836.6
Change	6.1%	11.6%	6.8%	7.0%
Share	66.0%	14.1%	19.9%	100.0%
1988	7,219.3	1,394.2	2,014.1	10,627.6
Change	11.2%	0.7%	2.9%	8.0%
Share	67.9%	13.1%	19.0%	100.0%

As for how the money was spent, the agency survey revealed that basic research remains a low priority despite government exhortations to the contrary (Table 2). The majority of natural science research funds, for example, continued to flow to developmental research in the year through March 1989, underscoring the strong emphasis Japanese firms place on quick conversion of technological advances into commercial products. Applied research, one step away from actual products, grew almost as much as developmental research but remained far smaller. Basic research grew a paltry 3 percent in FY 1988, highlighting the nation's weakness in this area.

According to two other sources, Japan's R&D spending has continued to expand smartly in FY 1989. An Economic Planning Agency survey released last November predicted that Japan's manufacturing sector would spend in excess of Y3 trillion ($21.4 billion) on R&D in the year ending March 31, 1990. This record achievement caps a decade in which manufacturers' R&D outlays rose at an average annual rate of more than 10 percent. Responding to American fears that this strong spending growth would encourage an export surge, an EPA spokesman emphasized that the money was not being used for capacity expansion. If research spending leads to products that embody more technology and therefore higher value-added, however, constant or declining export volumes could be offset by increases in unit export values.

Table 2: Japan's Natural Science Research Expenditures by Purpose, FY 1984-FY 1988

(in billions of yen and percentage share)

Fiscal Year	Basic Research	Applied Research	Developmental Research
1984	Y959.9	Y1,780.8	Y4,340.2
	13.6%	25.1%	61.3%
1985	1,030.6	2,001.8	4,985.9
	12.9%	25.0%	62.2%
1986	1,102.8	2,030.8	5,185.0
	13.3%	24.4%	62.3%
1987	1,250.2	2,166.8	5,497.3
	14.0%	24.3%	61.7%
1988	1,288.0	2,346.6	6,041.0
	13.3%	24.3%	62.4%

Source for Tables 1-2: Management and Coordination Agency, Report on the Survey of Research and Development.

The Japan Development Bank painted an even rosier picture of corporate R&D spending in FY 1989. An October JDB survey showed research expenditures by all industries rising 20.4 percent. Leading with an 80.2 percent increase were electric utilities; nonmanufacturing businesses were expected to spend 53.8 percent more in the current fiscal year, and manufacturing industries, 16.6 percent more. Within the manufacturing sector, electric machinery makers topped the list with a 54.9 percent increase, followed by food processors (42.7 percent), shipyards (31.9 percent) and chemical companies (28.5 percent). The nonelectric machinery and automotive industries showed increases of just 7.6 and 6.4 percent, respectively. Washington recently expressed concern that the capital spending plans of Japanese automakers may foreshadow a worsening of bilateral trade in cars.

The JDB survey diverged from mainstream opinion, however, by predicting that industrial R&D outlays will grow a meager 1.5 percent overall in FY 1990. EPA remains confident that research spending by the manufacturing sector will accelerate as Japanese companies realize the need to increase basic research efforts. As the Management and Coordination Agency's figures show, however, this realization may be some time in coming.

In the United States the debate concerns current corporate R&D spending. According to a new report by the National Science Foundation, research expenditures by American corporations fell in 1989 after adjustment for inflation, capping a worrisome trend that began in 1985. Between 1976 and 1985, according to NSF, corporate R&D grew at an average rate of 12.7 percent a year. Since then, however, the annual growth rate has withered to just 1.6 percent. From the viewpoint of some private surveys, however, the picture is not at all grim. According to Business Week's annual survey of research spending, American industries spent $59.4 billion in 1988, a gain of 11 percent. On top of fears that military R&D funds will be slashed, the conflicting figures are sure to obscure further already confused discussions over whether the United States should change its traditional approach to industrial development.

Jon Choy

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JEI

REPORT

A Two-Part Report: A and B

NO. 6A February 9, 1990

BIOTECHNOLOGY IN JAPAN: 1990 UPDATE

Summary

Barely a decade after its birth, Japan's biotechnology industry is showing signs of both youth and maturity. Since JEI last surveyed this topic (JEI Report No. 5A, February 7, 1986), a handful of products incorporating biotechnology has reached Japanese consumers, in some cases meeting with resounding success. The scope of biotechnology in Japan, however, is expanding so rapidly that the term bioindustry or life industry has been coined to include such nontraditional applications as bioactive intelligent materials. The biotech bandwagon is attracting an increasingly diverse group of Japanese companies with long-term commitments in mind. The Japanese government continues to encourage this trend with support for basic and long-term research and commercialization efforts. Being younger than the U.S. or European biotech industries, Japan's has not yet begun to seriously grapple with difficult issues such as bioethics, intellectual property issues or regulatory standards. Although most Japanese still consider their industry to be trailing American and European competitors, they are equally confident that Japan will play a major role in the global biotechnology industry.

Entering Adolescence?

It has taken three decades for scientists to transform a basic understanding of the structure of the gene (a sequence of deoxyribonucleic acid (DNA) that controls the expression of a trait in an organism) into products that affect everyday lives. Despite its tardy birth in 1980 (more than half a decade behind the United States and Europe), the Japanese biotech industry has not been far behind its American and European counterparts in the introduction of biotech products. Although this is due in large part to active licensing of foreign technology by Japanese firms, homegrown products are also for sale.

Not surprisingly, medical testing and pharmaceutical markets have the greatest number of biotech products. Products isolated and analyzed via biotechnology but produced by traditional means have become almost commonplace as have goods produced with biotech from start to finish. A wide range of diagnostic kits using biotech reagents are available in both the medical and the agricultural fields. Several substances that occur naturally within the human body now are on sale for therapeutic use thanks to biotechnology, including human growth hormone, antitumor treatments and agents that either dissolve or encourage blood clotting. Industry observers report at least four dozen biotech drugs in the clinical testing pipeline that should come to market within five years.

Biotech's presence in the food and agriculture sectors also is growing. Pesticides composed of genetically altered or specially selected naturally occurring bacteria are gaining wider acceptance in the face of consumer concerns over traditional chemical agents. Japanese consumers also can purchase four wines made with biotechnologically developed yeast cultures and a vegetable that exists only because of cell fusion technology and in vitro cell growth techniques. A few food testing kits using the targeted properties of monoclonal antibodies are coming to market. Most analysts agree, however, that it will be five to 10 years before biotechnology has a significant impact on Japan's seed, fresh vegetable and processed food markets.

Biotech cosmetics and cleaners have given their makers an edge over rivals in intensely competitive domestic markets. While canny marketing plans certainly have contributed to the commercial success of these products, the fact that the goods live up to manufacturers' performance claims, according to consumer surveys, plays an equally important role. Shiseido Co., Ltd. and Kao Corp. are both contemplating overseas launches of their biotech products.

In addition to companies strengthening their traditional product lines through biotechnology, a second wave of companies has seized upon the know-how as a means to diversify. Yamasa Shoyu Co., Ltd. realized several years ago that demand for soy sauce would weaken as foreign foods increasingly became a part of Japanese life. At first focusing on other food flavorings based on amino acids (the building blocks of proteins), Yamasa then jumped into the biochemical reagent market using expertise gained with nucleic acids in flavorings. Yamasa currently supplies nucleic acids critical to producing some drugs, such as beta interferon and azidothymidine (AZT), as well as diagnostic tests using monoclonal antibodies. Similarly, Kirin Breweries Co., Ltd. is using experience gained in improving the hops and grains used in its traditional beer products to expand into asexual plant reproduction and genetically modified seeds. Of perhaps more interest, however, are the activities of Japanese corporations outside the traditional scope of biotechnology.

Birth of a Bioindustry

Companies that appear to have no logical interest in biotechnology are devoting research funds to this field in both the United States and Japan.

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According to U.S. analysts, most American firms with significant research programs are funding biotech research. In Japan, however, biotech still has the aura of a competitive panacea, attracting participation from an even broader spectrum of businessmen -- more than 600 firms by some estimates. Total Japanese corporate spending in this field generally still is acknowledged to be less than what American firms allocate, but the research also is said to be more focused and aimed chiefly at commercialization.

"Intelligent" materials is the name of a broad category of both organic and inorganic substances that have been tailored at the molecular level for a specific purpose. Through an understanding of how animal or plant biological systems work and of how proteins and other macromolecules are constructed, engineers in a wide range of fields hope to custom design substances with novel qualities. In this area biotechnology overlaps with research into new materials, another area of great interest to Japan. The best-known application of intelligent materials is biosensors, which use proteins connected to electronic devices to measure or detect organic and inorganic substances with great sensitivity or rapidity. Japanese firms are exploring intelligent membranes, coatings, paints, dyes and adhesives.

Biomimetics are artificial products that mimic the function of an organ, body part or biological material. Although biomimetics are not necessarily produced via biotechnology, biotechnology often plays a major role in developing a thorough understanding of the biological archetype that the biomimetic is to replicate. Artificial skin, artificial blood vessels, synthetic ocular lenses all are under development by Japanese companies and often by companies that have no previous experience in the field. Some textile companies, for example, are working on artificial skin and blood vessels using synthetic fibers as a structural matrix. Some biomimetics rely solely on inorganic substances, ceramic bones and teeth for example, while others strive to integrate organic and inorganic materials, as in artificial ligaments.

Japanese progress in bioelectronics is being described as "groping in the dark." At present, many firms are hoping that government-funded projects explicating how the human brain thinks, stores memories and transfers information eventually will lead to electronic devices based on organic molecules, most likely proteins. Such devices would be "assembled" by enzymes under the guidance of artificial genes and consist of molecule-sized components in a three-dimensional arrangement. Bioelectronics promises not only greater speed and compactness than current inorganic electronics but also the potential to exhibit self-regulating and self-repairing abilities. Such devices may be able to endure harsher environments than current equivalents and be shaped to fit any desired space. Most major Japanese computer companies have allocated some money for bioelectronics research to be able to continue to compete if tomorrow's computers look like blobs of gelatin.

Environmental concerns are generating much broader interest in biotechnology than before. Waste treatment firms were early devotees of biotechnology for obvious reasons. Now, however, packaging companies, paper companies, plastics makers and practically every other user of environmentally questionable materials is looking to biotechnology for answers. Some studying the greenhouse effect feel that the ideal answer to too much methane, carbon dioxide, sulphur dioxide and other gases in the atmosphere may be biological processes that fix the gases in solid form. Biotechnical pollution control devices may be in the offing.

Research on outer space applications of biotechnology were dormant in Japan until recently. Problems with the U.S. space shuttle and Japan's nascent efforts to develop a domestic space launch capability dissuaded Japanese firms from investing in microgravity bioprocessing. Excitement over the U.S. space station and even more ambitious plans for manned facilities on the moon and, later, Mars have attracted a host of Japanese entrants. Japanese construction firms, surprisingly, are leading the charge. As part of their efforts to develop extraterrestial habitats they are investigating closed-cycle atmosphere, food and waste-handling systems in which biotechnology will play a major role. Such research clearly is long-term and highly speculative, an approach encouraged by the government.

Government Support

The private sector's focus on commercial R&D concerns government officials who understand the very close link between basic and applied science in biotechnology. Although small compared to U.S. government support for biological science research, every cabinet-level agency allocated some funds or cooperated in some biotechnology project in FY 1989 (see Table). Some participation clearly is token and biotechnology projects are often subsumed under a general category (particularly in the case of cancer research), making it impossible to determine an exact figure for total spending solely on biotechnology. Nevertheless, the bulk of activity is concentrated in a handful of organizations.

- The Ministry of Agriculture, Forestry and Fisheries budgeted a total of Y3.78 billion ($27 million at Y140=$1.00) in FY 1989 for biotechnology and related research. MAFF projects are quite straightforward, dealing mainly with improving plant and marine resources by developing biotechnology techniques and establishing germ plasm repositories.

- The Ministry of Education plays the key role in basic biotechnology research through its support of the national university system and scientific exchange programs. Since researchers within each university set their own research goals, MOE outlays for biotechnology are difficult to calculate. Its National Gene Laboratory (Y196 million or $1.4 million) and international cooperative recombinant DNA programs (approximately Y20 million or $143,000) are exceptions.

- The Ministry of International Trade and Industry has scattered biotechnology projects throughout its broad research funding. Not only is the application of biotechnology in next-generation industries being explored, but its role in revitalizing "old" industries, such as chemicals and mining, also is receiving attention. All told, MITI budgeted about Y6.4 billion ($45.7 million) for biotechnology programs in FY 1989.

- The Science and Technology Agency's support for biotech is divided into two main areas. Cancer research consumed Y8 billion ($57.2 million) in FY 1989, but this included nonbiotech programs as well. The Human Frontiers Science Program, the other main initiative, draws Y1.5 billion ($10.4 million) from STA, and is conducted in cooperation with MITI (which allocated Y932 million or $6.7 million to the project).

HFSP was proposed in 1987 by then Prime Minister Yasuhiro Nakasone at the Venice summit of industrialized nations. In effect, Tokyo is footing the

Japanese Government Biotechnology Research Budget, FY 1988-FY 1989

(in millions of yen)

Agency/Program	FY 1988	FY 1989
Science and Technology Agency		
Human Frontiers Science Program	Y0	Y1,456
Life sciences		
Human biology, aging, brain functions, etc.	2,057	1,861
Cancer research*	6,253	8,014
Environment Agency		
Effluent processing system	245	177
Water pollution treatment	436	382
Solid waste management	146	132
Pollution spill prevention/cleanup*	269	278
Ministry of Education		
Cancer research*	2,207	2,182
National Gene Laboratory	186	196
International recombinant DNA research*	0	66
Ministry of Health and Welfare		
Cancer research*	1,783	1,805
Solid waste management*	95	61
International cancer research	115	129
Pharmaceutical research*	2,600	2,400
Ministry of Agriculture, Forestry and Fisheries		
Basic biotechnology projects	3,665	3,784
Biological information project	167	477
Biological resources evaluation	435	406
Increasing plant yields	448	458
Bionusery system	39	47
Plant cell recombinant DNA	79	81
Advanced biotechnology projects	100	103
Biotechnology promotion at the local level	256	258
Gene bank project	498	513
Other	1,643	1,441
Food industry biotechnology	610	599
Large, high-pressure processing systems	0	139
Agricultural chemicals	0	52
Bioreactor research	235	92
Food testing and purification	106	103
Other	269	213
Local-level projects	200	212
Ministry of International Trade and Industry		
Human Science Frontiers Program	0	932
Next generation basic industrial technology	1,185	1,160
Bioreactors	197	0
Cell culture technology	422	360
Recombinant DNA technology	319	306
Biomaterials	247	343
Large-scale industrial technology	2,209	2,802
Marine resources*	20	275
Marine technology (Aqua Renaissance '90)*	2,189	2,527
Industrial biotechnology promotion	253	257
Alternative energy		
Alcohol technology	439	518
Biomass projects	15	0
Other	571	1,008
High efficiency alcohol production	190	190
Special projects*	287	310
Mine effluent treatment	53	52
Surveys	0	430
Sunshine plan, bioenergy project	41	26
Industrial base promotion	149	145
Bioindustry promotion	7	6
Bioprocess promotion	5	5
Bioengineering standards	18	13
Bioengineering data base	28	28
Biotechnology patent center	91	93
Safety programs	165	169
Recombinant DNA programs	4	4
Product safety standards	0	50
Outdoor recombinant DNA experiment guidelines	161	101
Biotechnology safety standards	0	14
International cooperation	311	424
Biochemistry projects	4	19
Eucalyptus project (Indonesia)*	0	15
International projects*	303	401
Ministry of Transportation		
Marine research*	95	149
Ministry of Posts and Telecommunications		
High-speed coding technology based on the functioning of the brain	20	24
Network-human interface research*	0	18
Ministry of Construction		
Waste treatment system*	149	114

*Not solely for biotechnology research

Source: Japan Society for the Promotion of Science, Japan Scientific Monthly bill for Japanese and foreign researchers to explore fundamental biological functions. The idea was so unprecedented that it not only took the ministries a year to agree on the program's basic outline before Mr. Nakasone could announce it, but it took another two years before the program could be initiated. HFSP will focus on two areas: elucidation of how the human brain functions and analysis of biological functions at the molecular level. Originally seen as costing Y1 trillion ($7.1 billion) and lasting 20 years, HFSP has been scaled back to more manageable dimensions. Its first-year agenda will include about 20 three-year, $500,000 research grants, 100 two-year, $100,000 fellowships, 50 short-term, $10,000 fellowships and 10 $10,000 workshops, for a total of around $20.6 million.

International reaction to the program was one of great skepticism. After Tokyo filled in details about funding, intellectual property rights and who would control the research agenda, however, foreign researchers have signed up. While Tokyo sees HFSP as one way of contributing to the global store of knowledge, some foreign observers still feel it is an effort by Japan to buy its way into biotech using foreign labor. Tokyo's commitment to the program, now headquartered in Strasbourg, France, will be watched carefully in years to come.

One area of intense Japanese interest is marine biotechnology. Faced with declining fish stocks in home waters and bans on fishing in waters controlled by other nations, Japan is turning to biotechnology to sustain this important food source. MAFF is focusing on how biotechnology can improve fish resources: larger fish; fish that produce offspring of only one sex; fish that produce more eggs; fish that are genetically programmed to return to their spawning site when mature.

The Environmental Agency and MITI are developing waste treatment and environmental recycling systems based on biotechnology. MITI also is exploring how biotechnology can help extract and refine organic and inorganic materials from the sea and the seabed. In light of ambitious plans to build floating as well as submarine habitats for its population, Japan can be expected to make significant contributions in the area of marine biotechnology.

The rapidly increasing senior citizen population is also driving Japan's biotechnology programs in new directions. There is great concern about the possible economic and social impact of senility and other age-related syndromes in light of lengthening life expectancies and a shortage of younger workers. Projects aimed at understanding the molecular basis of aging, at how the mind stores memories and transfers information and at how cells repair themselves spring from this demographic trend.

Tokyo also supports biotechnology through a system of quasi-governmental organizations. Being outside the traditional Japanese R&D structure, some of these organizations have been successful in sponsoring innovative basic research.

The mission of the Research and Development Corporation of Japan (JRDC), owned and operated by the Japanese government, is to promote basic research with current scientific and social issues in mind. JRDC was created to take over management of the Exploratory Research for Advanced Technology (ERATO) program set up in FY 1981 under the auspices of the Science and Technology Agency. ERATO's purpose is "to foster the creation of advanced technologies and advancing future interdisciplinary scientific activities while searching for a better system of basic research." Each ERATO project receives up to Y2 billion ($14.3 million) over a five-year period. Spending decisions are made by the head of each project, normally a well-respected researcher from a private company or a public laboratory. Eighteen ERATO projects were in operation or completed in FY 1989 with another three planned for FY 1990. The projects are roughly divided between the physical and the biological sciences. The latter group could make major contributions to the basic science that underlies biotechnology:

- Mizuno Bioholonics project (1982-1987) sought to understand how biological systems organize and process information through the synergistic activities of many units or holons.

- Hayaishi Bioinformation Transfer project (1983-1988) explored the role of prostaglandins in the central nervous system.

- Horikoshi Superbugs project (1984-1989) focused on finding microorganisms that can survive in extreme environments, determining which gene(s) control this trait and replicating them.

- Inaba Biophoton project (1986-1991) is exploring the light generating or absorbing capabilities of biological compounds.

- Hotani Molecular Dynamic Assembly project (1986-1991) is studying how biological systems use molecules to assemble other molecules.

- Kunitake Molecular Architecture project (1987-1992) is developing self-organizing molecular devices that have unusual capabilities.

- Mizutani Ecochemicals project (1988-1993) is exploring chemicals made by plants that affect other plants or animals in the immediate environment.

- Ikeda Genosphere project (1989-1994) seeks to understand how chromosomes exchange parts with other chromosomes during cell division.

The Institute of Physical and Chemical Research (Rikagaku Kenkyusho or RIKEN) was founded in 1917 with the support of the Imperial Household and private companies to provide an environment conducive to basic research. After undergoing wartime and postwar reorganizations, RIKEN was reborn in 1958, returning to its roots as a nonprofit research institute supported by public and private funds. RIKEN has four divisions -- Physics, Applied Physics and Engineering, Chemistry and Biology -- with 10 laboratories each. The Biology group is exploring the use of photosynthesis as an energy source, photochemical and photochemical/electrical reactions and biological control of insects. RIKEN's Life Science Center in Tsukuba is devoted almost exclusively to devoloping basic biotechnology. RIKEN launched the Frontier Research program in 1986 as an interdisciplinary approach to leading edge science. A major theme is understanding how living organisms maintain and regulate the myriad of processes that are going on within them in response to external and internal changes. This includes the molecular basis for aging and self-regulating mechanisms in plants.

The government also has resorted to the tried-and-true method of forming a research consortium of private companies using public funds, if with some slight twists. The Ministry of Agriculture, Forestry and Fisheries formed in 1986 the Bio-Oriented Technology Research Advancement Institution (BRAIN). BRAIN's 830 private corporate members can apply for low-interest government research loans for agricultural biotechnology research. The Ministry of Health and Welfare formed a similar organization the following year devoted to exploring the secondary effects of drugs and the aging process. While these efforts sound impressive, in fact many of the members joined for strictly financial reasons. Other companies participate in some parts of the research but not others. These groups have run into the usual problems: companies do not assign their best researchers to the project; firms stay away from areas where they have a lead over competitors; the government loans must often be repaid before the research generates profits; and there are disputes over intellectual property rights.

In a slight variation, MITI established the Key Technology Center in 1985 to act as a source of venture capital for innovative research. Among Key-Tech's investments are the Protein Engineering Research Institute and P.C.C. Technology. The former is a group of 14 companies, led by Mitsubishi Chemical Industries, Ltd. and Toray Industries Inc., focusing on industrial applications of engineered proteins. P.C.C. Technology, formed by Mitsui Toatsu Chemicals Inc., Kirin Brewery Co., Ltd., Kyowa Hakko Kogyo Co., Ltd. and four other companies, hopes to develop biotech mass production methods for dyes, perfumes and reagents based on plant-cell engineering.

Obstacles Ahead

Japan's biotech industry has yet to be plagued with the kind of fractious debates over nontechnical issues that have troubled American and European biotech industries. In part this is because Japan simply has followed the lead of the United States in adopting guidelines and safety requirements for biotech experiments and testing, certification, manufacturing and use of biotech products. Japanese society also lacks the tradition of open adversarial debate that has characterized the American approach to these issues. The public has left such decisions to scientists and bureaucrats, who, they feel, have the requisite knowledge to make the best choice. Growing public awareness of global environmental problems and a commitment to play a more active and responsible role in solving such issues as Third World development and North-South relations may spell an end to this quiet approach.

Regulatory/ethical issues - As biotechnology's scope expands and more products come to market, regulatory and ethical issues will become increasingly important. Perhaps the starkest example of the impact that regulations and social ethics can have on the biotechnology industry is the West German situation. Vehement opposition from proenvironment political parties and persistent memories of Hitler's "eugenics" program have combined to make Bonn's regulation of commercial biotechnology applications the strictest in the world. While research is relatively unrestrained, the introduction of genetically altered organisms into an open environment or the use of such microbes for commercial purposes triggers a daunting series of reviews, hearings and permit applications. It has reached the point where most West German firms pursuing biotechnology research have established major research centers outside the country, particularly in the United States. Foreign biotech firms interested in the European market do not consider West Germany a viable site for investment, instead choosing more friendly locations in Great Britain and the Netherlands.

While no one expects Tokyo to ever implement such harsh regulations, tensions are growing between an industry interested in quick commercialization of a wide range of products and a bureaucracy concerned with public safety. The Ministry of Health and Welfare, for example, maintains various approval procedures for items produced by recombinant DNA (rDNA) techniques and traditional chemical methods even when the final product is identical. Since the approval process for rDNA products is longer and more stringent, Japanese biotech companies complain that they are at a competitive disadvantage to those firms using traditional production methods. In addition, Tokyo continues to maintain a strict ban on the release of genetically altered organisms into the open environment, a situation more severe than a restrictive, but adaptable, U.S. attitude. Japanese firms simply have put all such experiments on hold until the government changes its attitude. As there are no signs that a change is in the works at this time, Japanese firms are resigned to moving the tests overseas or abandoning this field to the Americans.

Despite the degree of regulation, there has been almost no public debate over the ethical issues that underpin the government's stance. The rules allow no differentiation between technology that allows early detection of genetic diseases and that which allows employers and insurers to discriminate against those with genetic predispositions for certain ailments. As an example of the power of social mores to hinder technological development, a social taboo on life-sustaining organ transplants has restricted Japan's contribution in this promising medical field. Although this social aversion may be slowly eroding, Japanese researchers and companies continue to place a low priority on this technology.

The most extreme case of using biotechnology for genetic engineering -- that is, arranging for desirable traits in one's offspring -- is a definite possibility and poses extremely sensitive issues. The Japanese public's reticence to debate these options may not serve the country well in dealing with these issues, for if the government takes the easy way out and adopts foreign regulations that prove ill-suited to the Japanese situation, the biotechnology industry could suffer a major setback from a public backlash. At present there are the faintest signs that debate over such issues is beginning in Japan, but there is no way to predict their outcome.

Intellectual property issues - Equally problematic are intellectual property issues. As far as the patenting of genetically altered microbes, other products and biotech processes, Tokyo seems content to follow the lead of the United States, a tack that has drawn little public dissent. The U.S. model, however, may not be the best. American firms complain that the U.S. Patent and Trademark Office takes too long to process an application for biotech products. The PTO reportedly has accumulated a backlog of thousands of biotech applications while issuing decisions on less than a thousand a year. Furthermore, a patent in hand is no guarantee of a commercial monopoly because there are very few precedents to guide judges in biotech infringement cases. For example, a long-running battle between Amgen Inc. and Genetics Institute Inc. over an antianemia drug, erythropoietin (EPO), has taken surprising turns in recent months. In December a judge ruled that both companies were infringing on each other's EPO patents but that Chugai Pharmaceutical Co., Ltd., which had licensed the disputed technology from Genetics Institute and had U.S. marketing rights, was not infringing on Amgen's patents. Since many biotech products are exact or nearly identical copies of naturally occurring substances and since there is often more than one way to synthesize the substance, conflicts over process patents are inevitable.

Equally vexing is the growing debate over whether nations or individuals have ownership rights with regard to naturally occurring plants, animals or microbes. Biotech companies based in advanced industrial countries scour the globe looking for plants, animals and microorganisms with unique and desirable properties. Seeds of wild plants gathered in foreign countries provide the raw materials for advances in plant breeding; soil samples from around the world may contain the next powerful antibiotic; and cells removed from hospital patients can be grown outside the body and turned into a valuable commodity. There is a heated international debate over whether providers of basic biological material have the right to demand a share of any profits from products developed from that material.

Tokyo has yet to take a definitive position on this issue, but may find itself on the spot, particularly as it tries to respond to international pressures to play a larger role in world affairs and accept greater responsibilities. One area in which Tokyo hopes to showcase its new global status is Third World development and North-South relations. The debate over germ plasm ownership rights is an ideal opportunity for Tokyo to prove its mettle. There is as yet, however, no sign that Tokyo is willing to stake out an independent and perhaps controversial position.

Overseas Moves

Overseas ties continue to form an important part of Japanese biotech companies' strategy. Because cooperation between Japanese university researchers and private firms still is difficult to arrange, interest in tie-ups with foreign researchers remains strong. The United States is still viewed as being on the cutting edge of biotechnology research in most areas, attracting both Japanese and European research funds. Japanese companies are financing work at several U.S. institutions of higher learning, often in exchange for rights to commercialize any advances (see appendix). Newcomers to the prescription drug market, especially firms trying to diversify into new fields, are seeking to quickly build a niche by exchanging money for know-how.

Equally important are ties between Japanese and foreign firms, particularly in the pharmaceutical industry. While many of these links involve technology licensing, also common are distribution agreements and ventures aimed at shepherding new drugs through lengthy government approval procedures. Japanese drug companies understand that the global market will be increasingly treacherous and are trying to establish footholds in overseas markets to weather the assault of larger American and European drug companies.

U.S.-Japan Issues

Although the Europeans have several strong pharmaceutical companies involved in biotechnology, there is general international agreement that the United States and Japan will be the principal competitors. This situation poses the recurring conundrum that has pressured the alliance numerous times before: how to ensure that healthy competition in this commercial field does not threaten friendly overall relations. There is an unfortunate tendency in both countries to characterize the other as posing a life-or-death challenge in biotechnology. Both sides cite the "massive" spending going on in each country as the reason why still more must be spent or special steps taken at home. There are four particularly thorny issues:

Direct investment - A general perception by Americans -- that their firms are easy to acquire but that firms in Japan are not -- raises significant implications in the biotechnology arena. "Rich" Japanese drug, chemical and other companies are accused of gobbling up small, American biotech startups, draining them of their technology and then using that know-how to strengthen their own competitive position. Or Japanese competitors instantly can win a share of the U.S. market by purchasing an established American distributor or producer. U.S. firms complain that similar opportunities do not exist in Japan, although Merck & Co. sucessfully integrated Banyu Pharmaceutical Co., Ltd. into its operations in 1983.

Reciprocal opportunities would be difficult to achieve for two reasons. First, Japan's biotech industry is populated not by small startups but by medium and large established firms, which are not easily acquired. Second, despite figures showing that mergers and acquisitions in Japan are on the rise (see JEI Report No. 4B, January 26, 1990), traditional Japanese stockholding practices make such transactions difficult even for the Japanese. These two structural phenomena would be difficult, if not impossible, to change via negotiations.

Furthermore, American fears that foreigners are buying up the U.S. biotech industry ignore two things. Many small U.S. biotech startups would fold without cash. In the savings-poor U.S. economy, small firms often find it difficult to raise money. American biotech startups are striking more sophisticated deals with foreign partners, ensuring themselves of exclusive geographic marketing rights or insisting on provisions that prevent the foreign investor from becoming a direct competitor. Large American companies also are actively funding small startups in exchange for technology. Large companies cannot pursue all avenues of research, while small firms cannot afford to invest in full-scale production facilities. By working together, however, they can compensate for each other's weakness.

Technology transfer - Closely tied to the debate over whether the flow of foreign direct investment between the United States and Japan is unequal is the argument over whether the flow of technology is similarly unbalanced. In addition to concern that small American startups are selling their technology too easily or cheaply, some worry that Japanese competitors reap great windfalls from easy access to the U.S. university research system. Free access to the huge volume of basic research performed by American universities may compensate for Japan's acknowledged weakness in this area. Foreign access to Japan's university system is comparable in neither scope nor worth from the American standpoint. Because much of the cutting edge research in Japan is done by private firms, American researchers (academic or private) have little access to what Japan has to offer. Although the Japanese government and companies are expanding their programs for foreign researchers, the flow of information on biotechnology will remain in Japan's favor for some time, providing fuel for American technonationalists.

Patent issues - American displeasure with the Japanese patent system extends beyond the narrow field of biotechnology. Washington is unhappy with both the time it takes the Japanese patent office to process a patent application (an average of more than eight years) and with the quality of protection granted (for a full discussion see JEI Report No. 8A, February 24, 1989). Washington is not without sin in this area, however. While the overall average pendency period for a U.S. patent application is just 18 months, biotechnology patent applications reportedly require from two-and-a-half to four years to process. The Patent and Trademark Office has promised to speed the process by 1994, but this may be too late for many small American biotech firms. Current negotiations through the Uruguay Round of multilateral trade talks may yield a satisfactory global resolution to these issues. If not, then Congress or the U.S. court system will step in, a potentially less desirable situation for both American and foreign biotechnology concerns.

Cooperative research - Basic research is growing increasingly expensive as scientists pursue understanding at molecular and atomic levels. Since 1985 a semiprivate organization has been trying to launch an international program to determine the code of all human genes. The human cell has 23 pairs of chromosomes and each chromosome is composed of genes linked end-to-end as a strand of DNA. Each gene, in turn, is made up of a very specific (and often long) sequence of just four amino acids. All told, an estimated 3 billion amino acids joined in a very specific order is what defines humans and their unique characteristics. The Human Genome Initiative will take an estimated 15 years and $3 billion to fully decode every human gene. Project leader James Watson (who, with Francis Crick, first explained the structure of DNA) has raised $50 million from the Department of Energy and the National Institutes of Health and has attracted participation from laboratories around the world -- from everywhere except Japan, and that is where the problem lies.

Mr. Watson's plea for at least $300,000 a year from Japan fell on deaf ears, prompting him to threaten to withhold any results from reaching Japan. The problem appears to be that Tokyo has its own human genome project, and it claims that it cannot commit funds to an international project in an era of tight budgets. The Ministries of Health and Welfare and Education are funding genome sequencing efforts in Japanese laboratories to the tune of Y600 million ($4.3 million) and Y250 million ($1.8 million), respectively. STA is encouraging RIKEN to develop automatic gene sequencing equipment with about Y1 billion ($7.1 million) spread over several years. From a foreign standpoint it seems odd that these Japanese efforts, which amount to far more than what Mr. Watson sought, cannot be incorporated or integrated with the Human Genome Initiative, which would be of mutual benefit. Tokyo's stance is even more perplexing given its publicly professed desire to emphasize cooperative R&D and contributions to global science. It is possible that the lack of Japanese participation may become a source of friction, especially if the Human Genome Initiative receives congressional endorsement.

Outlook

Despite the relatively slow pace of commercialization and the potential for friction with the United States, Japanese optimism that biotechnology will sharply improve the globe's standard of living and become a huge commercial market is irrepressible. According to MITI's 1988 biotechnology "vision" or long-term outlook, the Japanese bioindustry in fiscal 1987 was worth Y400 billion ($2.9 billion), of which Y6.5 billion ($46.4 million) was derived from applications of biotechnology. The bioindustry market will grow to Y15 trillion ($107.1 billion) by the turn of this century with biotechnology accounting for Y4.6 trillion ($32.9 billion), MITI forecasts. Even if these estimates prove wildly optimistic, growth of the Japanese bioindustry probably will outpace every other sector.

According to private sector surveys by the Science and Technology Agency, Japan has set itself high goals. STA's annual white papers reveal a consistent opinion among Japanese scientists and businessmen that while Japan and the United States are about equal in terms of personnel and equipment devoted to biotechnology, the quality of U.S. basic research and the American potential for product development are both far ahead of Japan. (Interestingly, the same surveys show little Japanese regard for European biotechnology efforts.) It is therefore understandable that government programs focus on promoting basic research and the rapid introduction of biotechnology throughout Japanese industry.

Japan's biotechnology industry will continue to internationalize as foreign firms set up research centers in Japan and Japanese firms seek to build positions in markets around the globe. The thorny issues of freedom of foreign direct investment and balanced technology flows pose serious obstacles to the smooth development of Japan's bioindustry. Because these issues affect many industries besides biotechnology, solutions become both more important and more difficult. Questions about the longevity of the Liberal Democratic Party's dominance of Japanese politics plus the lack of a domestic consensus on many biotechnology issues makes quick resolution of frictions unlikely.

Given the enthusiasm of both the government and the private sector toward biotechnology, however, Japan surely will make major contributions to the field in research and commercialization. Whether Japan will make equally important contributions in the areas of bioethics and intellectual property rights is less certain but no less critical to its bid to be a major player in global biotechnology.

For further information contact, Jon Choy.

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The views expressed in this report are those of the author and do not necessarily represent those of the Japan Economic Institute.

Appendix: Transpacific Activities of Japanese and American Biotechnology Companies

Ajinomoto Co., Inc. - Wister Institute. Research project on a new cancer therapy. (01/87)

Life Technologies Inc. - Oriental Yeast Co., Ltd. Joint venture (Gibco Oriental K.K.) to market a new cell culture in Japan. (01/87)

Dainippon Pharmaceutical Co., Ltd. - Genentech Inc. U.S. firm licensed to produce and market Dainippon's tumor necrosis factor in all countries except Japan, South Korea and Taiwan. (02/87)

Yamanouchi Pharmaceutical Co., Ltd. - T Cell Sciences Inc. Three-year product development agreement for autoimmune diseases and cancer diagnostic products. U.S. firm provides proprietary technology and retains all rights except marketing rights to the new products in Japan, which Yamanouchi will have. (03/87)

Toyo Soda Mfg. Co., Ltd. - U.S. biotechnology research office planned to gather information on genetic engineering, cell fusion and recombinant gene technologies. (03/87)

Upjohn Pharmaceuticals Ltd. - R&D facility in Japan (completed in the fall). (03/87)

Nippon Steel Corp. - Calgene Inc. The Japanese firm will fund Calgene's development of vegetable oil for industrial use in exchange for exclusive marketing rights in the Pacific. (05/87)

Centocor Inc. - Ajinomoto Co., Inc. Marketing tie-up in Japan for U.S. firm's pancreatic cancer drug therapy. (05/87)

Toyo Kasei Kogyo Co., Ltd. - R&D center in Portland, Oregon for manufacturing drug intermediates and raw materials. (06/87)

Toray Industries Inc. - Arthur D. Little Inc. Tie-up to assist Japanese firms in filing life-science registration and product-safety test with U.S. government agencies. (06/87)

Zymogenetics Inc. - Teijin Ltd. U.S. firm licensed its technology for genetically engineered protein C., an anticoagulant. (07/87)

Phillips Petroleum Co. - Kyowa Hakko Kogyo Co., Ltd. U.S. firm to use its recombinant DNA technology to produce salmon growth hormone for Japanese company. (07/87)

Genetics Institute - Neorx Corp. Pooling their efforts to offer their cancer drugs in Japan.

Mochida Pharmaceutical Co., Ltd. - National Cancer Institute. Japanese firm to supply a new beta-type interferon. (08/87)

Murex Corp. - Kyowa Medex Co., Ltd. Joint development of a new line of rapid monoclonal antibody-based assays to screen and diagnose AIDS. Production to be in the United States. (08/87)

Genentech Inc. - Mitsubishi Chemical Industries Ltd. Joint biotechnology marketing agreement. Possible joint research. (08/87)

Applied Biotechnology Inc. - Mitsubishi Corp. Marketing agreement for U.S. firm's live virus vaccine in Japan. (08/87)

Summa Medical Corp. - Cosmo Medical Co., Ltd. Marketing agreement for U.S. firm's monoclonal antibody vaccine in Japan. (08/87)

The Michigan Biotechnology Institute - Marubeni Corp. Marketing agreement for biotechnology products and processes. (08/87)

Teijin Ltd. - Bio-Science Enterprises Inc. Japanese firm acquires American half of joint venture Teijin Bio-Science Laboratories Inc. formed in 1977. (09/87)

Pragma-Biotech Inc. - Eiken Chemical Co., Ltd. After reviewing the U.S. firm's proprietary information on cancer-related biochemical and immunological methods, Japanese firm to decide whether it will underwrite a portion of the U.S. firm's R&D. (10/87)

Taisho Pharmaceutical Co., Ltd. - Liposome Co. Japanese firm licenses North and Central American marketing rights to its liposomal cardiovascular drug. (01/88)

Suntory Ltd. - Smithkline Beckman Corp. Joint pharmaceutical research and development. (01/88)

Charles River Biotechnical Services Inc. - Its Japanese subsidiary to import Opticell animal cell culture equipment and handle production of monoclonal antibodies for biotechnology firms. (01/88)

Nitto Boseki Co., Ltd. - Subsidiary in Iowa to produced antisera for diagnostic drugs as well as engage in biotechnology research with the University of Iowa. International Immunology Corp. of California, another Nitto subsidiary, will market products. (02/88)

Smithkline Beckman Corp. - Fujisawa Pharmaceutical Co., Ltd. To exchange ownership of their two equally owned joint ventures, leaving the U.S. firm with Smithkline Fujisawa K.K. in Tokyo and the Japanese firm with Fujisawa Smithkline Corp. of Philadelphia. (02/88)

Takeda Chemical Industries, Ltd. - Abbott Laboratories. Joint R&D in America and a manufacturing joint venture in North Chicago since 1977. (03/88)

Hitachi Chemical Co., Ltd. - Biotechnology research center at the University of California, Irvine. (04/88)

Chugai Pharmaceutical Co., Ltd. - Gen-probe Inc. Japanese funding for development of eight viral and two cancer diagnostic products in exchange for exclusive rights to distribute the products in Japan and other selected Asian countries. Gen-probe retains marketing rights elsewhere, subject to payment of a royalty to Chugai for products developed with its funding. (05/88)

Green Cross Corp. - International Genetic Engineering Inc. Joint development of monoclonal drugs for cancer. (05/88)

Olympus Optical Co., Ltd. - Biotechnology laboratory set up in New York City suburb. (05/88)

Eisai Co., Ltd. - Laboratory in Andover, Massachussetts for basic research on antibiotics and drugs to combat senile dementia. (06/88)

Tanabe Seiyaku Co., Ltd. - Immunetech Pharmaceuticals Corp. Limited acquisition (9.5 percent) gives Tanabe exclusive Asian marketing rights to all Immunetech compounds. (06/88)

Fujirebio Inc. - Subsidiary in New Jersey to oversee new drug applications and marketing.

United Biomedical Inc. - Olympus Optical Co., Ltd. Joint development of reagents and marketing agreement in Japan. (06/88)

Chugai Pharmaceutical Co., Ltd. - Upjohn Co. Joint venture to develop and market Chugai's pharmaceutical products in North America. (07/88)

Ajinomoto Co., Inc. - Bristol-Myers Co. Japanese firm to provide two AIDS drugs, DDA and DDI. (08/88)

Nissin Food Products Co., Ltd. - Its Nissin Molecular Biology Institute formed to develop AIDS drugs. (08/88)

California Biotechnology Inc. - Daiichi Seiyaku Co., Ltd. Japanese firm's financing allows it to share U.S. and Canadian marketing rights on an amyloid protein linked to Alzheimer's disease and gives it exclusive rights for the rest of the world. (08/88)

Native Plants Inc. - Kyowa Hakkc Kogyo Co., Ltd. - Sumitomo Corp. Joint venture for research in Japan on improved grain varieties through biotechnology. (08/88)

Otsuka Pharmaceutical Co. Ltd. - Micro Vesicular Systems Inc. (an ICI Inc. subsidiary). Joint product development of liposomally encapsulated drugs to treat eye diseases. (09/88)

Bristol-Myers Co. - Sumitomo Metal Industries, Ltd. Joint venture in Japan for conducting immunity tests and other diagnostic procedures and developing diagnostic drugs and medical equipment. (09/88)

Genetic Designs Inc. - Kurabo Industries, Ltd. Agreement for Japanese firm to market U.S. company's synthetic DNA materials. (09/88)

Eli Lily & Co. - A 1983 joint venture between its Hybritech, Inc. subsidiary and Tosoh Corp. dissolved. Tosoh bought its former partner's reagent technology. (09/88)

Chugai Pharmaceutical Co., Ltd. - Upjohn Co. Jointly seeking U.S. government approval for an anemia treatment licensed to Chugai by Genetics Institute, Inc. (10/88)

Kyowa Hakko Kogyo Co., Ltd. - Integrated Genetics Inc. Jointly developing a blood protein essential to regulating platelet production. (10/88)

Itoham Foods Inc. - Biotechnology subsidiary formed in California to produce and market synthesized peptides for medical reagent uses. (10/88)

Eisai Co., Ltd. - Subsidiary set up in New Jersey for clinical testing of antibiotics and drugs. (10/88)

Epitope Inc. - Sakata Seed Corp. One-year pact to explore the use of a gene isolated by Epitope that appears to control a hormone that produces ethylene. (10/88)

Southern Research Institute - Nissho-Iwai Corp. The Japanese firm to seek clients interested in consigning to the Alabama firm their biotechnology experiments. (10/88)

Calpis Food Industry Co., Ltd. - Genentech Inc. Japanese firm licensed its technology for producing the RGF hormone in the development of kidney disease treatments. (12/88)

Kirin Brewery Co., Ltd. - Its biotech research subsidiary will contribute $4 million annually to the La Jolla Institute for Allergy and Immunology. (12/88)

Bio-Technology General Corp. - JCR Pharmaceuticals Co., Ltd. U.S. firm licensed JCR to exclusive Japanese distribution rights for its human growth hormone. (12/88)

Genentech, Inc. - Cancer Center Research Laboratory. Joint research on a gene that inhibits the growth of monocytic leukemia cells in mice. (12/88)

Mitsubishi Kasei Corp. - Kyowa Hakko Kogyo Co., Ltd. - Genentech Inc. Japanese firms helping to get license for blood-clot dissolving agent produced by Genentech. (12/88)

E.I. Dupont De Nemours & Co. - Biotech Research Laboratories Inc. - Sanko Junyaku Co., Ltd. U.S. firms jointly developed AIDS diagnostic kit in Japan. (12/88)

Clonetics Corp. - Kurabo Industries Ltd. Jointly developed a kit to test toxicity of new drugs and cosmetics on human skin. (12/88)

Agri-Diagnostics Associates - Toyo Green Co., Ltd., a subsidiary of Toyo Menka Kaisha Ltd. Japanese firm gets exclusive distribution rights in Japan for U.S.-produced turf disease detection kits. (12/88)

Sumitomo Chemical Co., Ltd. - Regeneron Pharmaceuticals Inc. Japanese firm backs nervous system disorder research in exchange for Japanese marketing rights. (01/89)

Genetics Institute Inc. - Suntory Ltd. Japanese firm buys marketing rights for clot-dissolving agent in Japan, South Korea and Taiwan. (01/89)

Vigilant Products, Co., Inc. - Shikoku Chemicals Corp. Japanese firm to market U.S.-made wastewater treatment enzymes. (01/89)

Mitsubishi Kasei Corp. - Genentech Inc. U.S. firm to conduct clinical trials of Japanese company's blood-clot dissolving agent. (02/89)

California Biotechnology Co. - Kaken Pharmaceutical Co., Ltd. Japanese firm to help with clinical tests of basic fibroblast growth factor. (02/89)

Hitachi Chemical Co., Ltd. - Mast Immunosystems Inc. Japanese firm consigns testing of diagnostic agents to U.S. company. (03/89)

Japan Tobacco Inc. - Mycogen Corp. Joint venture to develop herbicides using microorganisms. (04/89)

Mitsubishi Corp. - Battelle Memorial Institute - Nova Pharmaceutical Corp. Japanese firm to finance research in the United States. (04/89)

Takara Shuzo Co., Ltd. - U.S. subsidiary of Japanese brewer to sell biotechnology products. (05/89)

Schering-Plough Corp.- Kyoto University of Medicine. Cooperative research on leukopenia treatment. (05/89)

Yamasu Shoyu Co., Ltd. - Squibb Corp. U.S. firm gains foreign marketing rights to anti-herpes medication. (06/89)

SS Pharmaceutical Co., Ltd. - Baker Cummins Pharmaceutical Inc. Joint development of AIDS vaccine. (06/89)

Abbott Laboratories - Toyo Menka Kaisha, Ltd. Japanese firm to market biotic pesticide in Japan. (07/89)

United Biomedical Inc. - Olympus Optical Co., Ltd. Japanese firm gains exclusive global marketing rights to AIDS test. (07/89)

Morinaga & Co., Ltd. - Sumitomo Corp. Japanese firms to test microbial pesticide in the United States. (08/89)

Marubeni Corp. - Harris Laboratories Inc. American firm will handle clinical experiments for Japanese firm's clients. (08/89)

Fujisawa Pharmaceutical Co., Ltd. - Lyphomed Inc. Japanese firm acquires Rosemont, Illinois generic drug maker. (09/89)

Shiseido Co., Ltd. - Massachusetts General Hospital. Japanese firm establishes Cutaneous Biology Research Center. (09/89)

NKK Corp. - Battelle Memorial Institute. Joint research on vaccines against respiratory viruses. (10/89)

Yamanouchi Pharmaceutical Co., Ltd. - Beecham Group Plc - T Cell Sciences Inc. Japanese and British firms commission arteriosclerosis research. (10/89)

Biotechnology General Corp. - Nippon Chemical Research Co., Ltd. Japanese company to market American firm's hyaluronic acid developed through bacteria cultures for treatment of arthritis and cataracts. (10/89)

Kyowa Hakko Kogyo Co., Ltd. - Nutri-Quest Inc. American company to develop feeds, feed additives and pesticides with amino acids, enzymes and biotechnology of U.S. research arm of Japanese firm. (11/89)

Kurabo Industries, Ltd. - Clonetics Corp. Japanese spinning firm to market U.S.-developed bioassay toxicity kits. (11/89)

Chugai Pharmaceutical Co., Ltd. - Gen-Probe, Inc. Japanese firm purchases U.S. maker of DNA-based diagnostics. (12/89)

Gene Track Systems Inc. - Nissui Pharmaceutical Co., Ltd. Japanese firm wins exclusive marketing rights at home for DNA- and RNA-based diagnostics. (12/89)

Fujisawa Pharmaceutical Co., Ltd. - University of Pittsburgh. Joint clinical testing of Japanese firm's immunosuppressant. (01/90)

Chromatochem Inc. - NGK Insulators, Ltd. Japanese firm gets exclusive sales rights in Japan for antibody-antigen silica packing agent for affinity chromatography. Also joint development of advanced materials for ion-exchange and gas chromatography. (01/90)

Source: Japan-U.S. Business Report

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A Two-Part Report: A and B

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IN THIS ISSUE:

Japanese Banks, Government Part of Complex Mexican Debt Plan 1

Lower House Race Begins 3

Japan's Economy In 1989 Shows Effects Of Prolonged Expansion 5

Price Surveys, Rule Delay Cloud Import Liberalization 6

Senate To Consider Fair Trade In Financial Services Bill 8

Shipyard Talks Gaining Speed 10

Japanese Banks, Government Part Of Complex Mexican Debt Plan

As many financial experts have been focusing on how to facilitate international capital flows that are supposed to help jump start the economies of Eastern Europe, Mexico and its creditors have been putting the finishing touches on a debt-restructuring plan that Mexico City hopes will substantially ease the burden of servicing its outstanding loans from 450 foreign banks. Of the almost $50 billion in public sector debt owed to banks, Japanese institutions hold approximately one-sixth, second only to U.S. banks.

On February 4 the government of President Carlos Salinas de Gortari signed a formal agreement with foreign bank representatives in Mexico City. Generally, the pact follows the outlines of what has become known as the Brady Plan, named after U.S. Treasury Secretary Nicholas Brady. The plan, unveiled last March, has been seen as a major departure from the typical options obligations of the Mexican government, mainly at the cost of a potential loss to Tokyo and international financial organizations, such as the IMF.

Douglas Ostrom

Lower House Race Begins

Japanese politicians formally launched their campaigns February 3 for the February 18 House of Representatives elections amid rampant speculation about whether the opposition parties can knock the ruling Liberal Democratic Party from the pinnacle of power it has enjoyed since 1955. In an effort to exploit the reform movement that is sweeping the Soviet bloc, Prime Minister Toshiki Kaifu presented the lower house contests as a critical choice for voters between democracy and socialism. The three major noncommunist opposition parties pledged to cooperate among themselves in ending the "dictatorial and money-oriented LDP regime" and abolish the controversial 3 percent consumption tax. At this stage few are betting with assurance about who will be selected by Japan's 90 million voters among the record field of 953 candidates (see chart).

Candidates Running For Lower House Elections

Party	Incumbents	Former Office Holders	New	Total Candidates	Seats Won in 1986
Liberal Democrats	270	8	47	325	304
Japan Socialists	67	17	64	148	86
Komeito	42	0	16	58	57
Democratic Socialists	20	7	17	44	26
Japan Communists	23	12	96	131	27
Minor parties	5	0	72	77	10
Independents	5	4	161	170	2
Total	432	48	473	953	512

Source: Japan Times, February 4, 1990.

Borrowing a page from the American book on campaigning, the major political players squared off February 2 during Japan's first televised debate in 30 years prior to a lower house election. The three-hour session sponsored by the Japan National Press Club brought together LDP President and Prime Minister Toshiki Kaifu, Japan Socialist Party chairperson Takako Doi, Japan Communist Party chairman Tetsuzo Fuwa, Komeito chairman Koichiro Ishida and Democratic Socialist Party chairman Eiichi Nagasue. Mr. Kaifu generally emphasized that the ruling party's leadership acumen, acquired after 35 years at the Japanese government helm, will be critical as Japan and others in the Western alliance adapt to the new post-Cold War era. He contended that the Japan Socialist Party -- the country's largest opposition party -- sticks to the sort of outdated political and economic notions targeted for reforms in Eastern Europe and the Soviet Union. The prime minister also maintained that the noncommunist opposition parties would be unable to form a viable coalition due to policy differences.

Ms. Doi countered that her party supports the principles of democracy and soon would announce a new party platform. However, the JSP leader proposed no new initiatives to bridge policy differences with the Komeito and DSP. The Socialists, who favor a neutralist posture, part with the other two parties on the importance of the U.S.-Japan Mutual Security Treaty and whether it needs to be retained; they also support recognition of North Korea and oppose the use of nuclear energy. Referring to policies as the "life of political parties," Mr. Ishida suggested that a sharing of power among the LDP, JSP, Komeito and DSP might be unavoidable if the opposition parties cannot bend their views sufficiently. Presenting a rosier prospect, Mr. Nagasue said it was conceivable that he and his noncommunist colleagues could clear up their policy disputes "overnight" if they together garnered a majority in the lower house.

In a post-debate statement the DSP leader clarified that the noncommunist opposition parties' agreement to cooperate in usurping LDP control was not just an election strategy; a viable administration with a united platform could be formed, he said. However, Ms. Doi, terming this alliance a "people's coalition, not a party coalition," instead focused on the parties' unanimity in favor of abolishing the consumption tax and on social welfare matters.

Both the LDP and the JCP homed in on the apparently shaky foundation of a JSP-DSP-Komeito coalition. Mr. Kaifu compared Mr. Nagasue's comment to "overnight" agreements to a "student cramming the night before an examination." The JCP's Mr. Fuwa echoed the prime minister's sentiment but suggested that his party could cooperate with the other opposition parties on specific issues, such as abolishing the consumption tax and opposing liberalization of rice imports. Although the DSP's strong objections to the JCP effectively have barred the latter group from opposition party cooperation for nearly a decade, the Communists and several very small parties have lent important support to the noncommunist parties fighting LDP initiatives in the upper house.

A large portion of the debate revolved around an examination of Japan's international role, particularly its relationship with the United States. While all of the participants acknowledged the importance of bilateral ties, they disagreed on the nature of Japan's diplomacy toward the United States. Mr. Kaifu termed U.S.-Japan relations the core of Japan's foreign policy and sought to assure the electorate that, despite tensions over the trade imbalance, a major breach was not in the offing. The four opposition parties criticized the LDP for allowing bilateral tensions to mount. Mr. Nagasue called for the establishment of regular U.S.-Japan committee meetings to discuss bilateral issues. Ms. Doi, while stating her desire to visit the United States after February 18, nevertheless said that Tokyo should not follow lockstep Washington's foreign policy conduct.

Although all five participants agreed that Japan must prepare for a new international order, none presented specific policies to meet this challenge. The prime minister would say only that the trend toward arms reduction would help Japan play a more active role in global diplomacy. Two of the noncommunist opposition parties carefully sidestepped the security issue so as not to draw attention to a major obstruction to their political union. Ms. Doi, however, did propose the creation of an institution in the Asian Pacific region to help stabilize this part of the world during the transition to a new global order. The DSP's Mr. Nagasue stated that while the Mutual Security Treaty should be maintained he feels that Washington's demands for Japan to share more of the military burden even as U.S. defense spending is reduced amounts to a violation of "equal partnership." The JCP leader was the only participant to call outright for treaty revision in light of changes in the Soviet bloc and in U.S.-Soviet relations.

At one point Mr. Nagasue accused the prime minister of using foreign policy to divert the public's attention from the consumption tax and the ruling party's "money politics." Japanese political analysts have maintained that two of the factors that led to the LDP's stunning loss of its majority in the July upper house elections were the April 1989 implementation of the tax as well as the involvement of several senior LDP officials in the Recruit Co., Ltd. bribery scandal (see JEI Report No. 32A, August 18, 1989). Some analysts have suggested that the decision of former chief cabinet secretary Takao Fujinami and former Vice Minister of Education Kunio Takaishi to run for reelection -- despite both of them being indicted for allegedly taking bribes from the employment and information services conglomerate -- has refocused voter attention on an episode from which the ruling party had hoped to distance itself.

Barbara Wanner

Japan's Economy In 1989 Shows Effects Of Prolonged Expansion

While all the results will not be in for months, 1989 appears to have been a very good year for the Japanese economy. That conclusion emerges from annual data for 1989 released through the early part of February. For example, the widely watched index of manufacturing and mining production surged 5.9 percent for the year based on preliminary figures for December. While not as impressive as the 9.5 percent jump recorded in 1988, the growth was nonetheless remarkable considering that Japan was in the third full year of an economic expansion. The operating rate index through November for manufacturing firms rose 2.7 percent, indicating that firms were using their existing capacity more fully.

Another indication of growing tightness was reflected in labor market data. The effective job opening per applicant ratio soared to 1.25, the most favorable situation for those seeking work since 1973, suggesting that job openings exceeded those seeking work by about 25 percent. A year earlier, supply almost exactly had equaled demand when the ratio was at 1.01. The strength in the labor market also was evident in the unemployment rate, which dipped to 2.3 percent in 1989 from 2.5 percent a year earlier. (Japanese and U.S. unemployment data are not directly comparable in their recording of full-time workers, for example.) Labor market conditions have so far led to only a modest acceleration of wage increases. However, with employee earnings rising more rapidly and labor productivity growing more slowly, the decline in unit labor costs has slowed dramatically. In fact, by some measures, unit labor costs were increasing by the end of 1989. For these reasons, business leaders face with some trepidation -- and labor leaders with considerable hope -- the 1990 spring labor offensive (see JEI Report No. 4B, January 26, 1990).

Increasingly strained capacity, coupled with ever-tighter labor markets and a weaker yen, contributed to a moderately higher rate of inflation during 1989. Wholesale prices were 2.5 percent higher in 1989 than a year earlier on average, led by import prices, which increased 7.7 percent. Toward the end of 1989, import prices surged, rising by 14.8 percent in November and 15.3 percent in December over year-earlier levels. A combination of higher oil prices and a

RS650-2

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IN THIS ISSUE:

Current Account Drops Sharply In 1989 1

Japan's Financial Reform Schedule 4

Japan Is On Course
For Strengthening Antimonopoly Law 6

Japan Reacts To U.S. Defense Cuts Proposal 8

Hills Tells Capitol Hill
Of Trade Negotiation Progress 9

Japan-Taiwan Update 11

Notes: Socialist Tax Reform Plan 12

Current Account Drops Sharply In 1989

Officially, Tokyo and Washington agree on at least one important economic policy objective: Japan's huge balance of payments surplus should come down. But for years achieving such a goal has seemed like a search for the proverbial light at the end of the tunnel: real progress remained just around the next bend. Even when the broadest-based measure, the current account, declined -- as it did in 1988 -- economists ordered the celebrations canceled after deciding the light was a mirage, caused by some or another quirk in the data.

Toward the end of 1989, however, the figures began to shine a little more brightly. In the October-December period the current account deficit dropped a whopping 50.5 percent compared to the same period in 1988. The year-to-year comparison was distorted by an unusually large surplus a year earlier, but the 1989 figure was still impressive, being lower than any fourth quarter result since 1984.

Japan Economic Institute 1000 Connecticut Avenue, N.W., Washington, D.C. 20036 202·296·5633

For the year, Japan's dollar-denominated current account deficit declined 28.5 percent compared to 1988 -- from $79.6 billion to $57 billion -- pushing the figure to a level close to $49.2 billion achieved in 1985 (see Table 1). In addition, the surplus as measured in yen reached the lowest level since 1983. Furthermore, more than one factor contributed to the improvement. For example, not only did imports surge 16.8 percent, but exports rose a modest 3.8 percent. In addition, the final major component of the current account, services -- which include categories such as transportation, travel and investment income -- registered a deficit that was 41.4 percent larger than a year earlier. The increase in the services imbalance was largely a consequence of the deficit in tourism rising faster than the net surplus of investment income.

Table 1: Japan's Balance of Payments

(in millions of dollars, IMF value basis)

	1985	1986	1987	1988	1989*
Current Account	$49,169	$85,845	$87,015	$79,631	$56,975
Trade Balance	55,986	92,827	96,386	95,012	77,130
Exports (f.o.b.)	174,015	205,591	224,605	259,765	269,631
Imports (f.o.b.)	118,029	112,764	128,219	164,753	192,501
Services	-5,165	-4,932	-5,702	-11,263	-15,925
Transfers	-1,652	-2,050	-3,669	-4,118	-4,230
Long-Term Capital	-64,542	-131,461	-136,532	-130,930	-87,928
Basic Balance	-15,373	-45,616	-49,517	-51,299	-30,953
Short-Term Capital	-936	-1,609	23,865	19,521	20,825
Errors and Omissions	3,991	2,458	-3,893	2,796	-23,158
Overall Balance	-12,318	-44,767	-29,545	-28,982	-33,286

*Preliminary.

Source: Bank of Japan

Table 1 illustrates an important principal of the balance of payments: to the extent that the current account declines, as it did in 1989, international financial flows change as well. The current account surplus is partly offset by outbound long-term capital movements; the basic balance indicates the amount left to be covered by short-term private and official flows, partially represented in the table by short-term capital and errors and omissions. In recent years, the outbound long-term capital flows have been more than sufficient to cover the current account surplus, implying that the remaining figures showed a net inflow.

Table 2 gives some details of the long-term capital account. Note that it is dominated by two figures: an outbound flow of "ordinary bonds," which represent Japanese purchases of U.S. Treasury and other bonds on foreign securities markets, and an inbound flow of "external bonds," which are foreign purchases of bonds issued by Japanese firms on Euromarkets and elsewhere. While full-year data are not available, figures for the first half of 1989 suggest that the outflow is heavily toward the United States. The inflow comes overwhelmingly from Great Britain, a center of Euromarket activity.

Table 2: Net Long-Term Capital Flows

(in millions of dollars)

	1988			1989*		
	Outflows	Inflows	Net	Outflows	Inflows	Net
Direct Investment	$-34,210	$-485	$-34,695	$-43,786	$-1,080	$-44,866
Trade Credits	-6,939	-18	-6,957	-3,690	-7	-3,697
Loans	-15,211	-82	-15,293	-22,457	17,813	-4,644
Securities	-86,949	20,298	-66,651	-113,285	85,144	-28,141
Stocks	-2,993	6,810	3,817	-17,887	6,998	-10,889
Bonds	-85,812	-21,628	-107,440	-94,083	2,400	-91,683
Yen-Denominated Bonds Issued in Japan	1,856	n.a.	1,856	-1,315	n.a.	-1,315
External Bonds**	n.a.	35,116	35,116	n.a.	75,746	75,746
Other	-6,574	-760	-7,334	-7,558	978	-6,580
Total	-149,883	18,953	-130,930	-190,776	102,848	-87,928

Note: A negative sign indicates a capital outflow.

*Preliminary.
**Bonds issued outside of Japan by Japanese institutions.

Source: Bank of Japan

Wall Street gets jittery whenever it thinks that Japanese purchases of U.S. securities might slow, believing that Japanese investors are needed to keep pumping money into American markets to keep U.S. interest rates from soaring. This argument suggests that Wall Street -- absent changes in U.S. savings and investment behavior -- tends to prefer a large Japanese current account surplus to a smaller one.

In 1989, however, the decline in the current account -- and long-term net capital outflows -- was not accompanied by a decline in Japanese purchases of foreign long-term securities. In fact Japanese investors significantly *increased* their purchases of "ordinary bonds" such as U.S. Treasury bonds. Instead, the inflow of external bonds increased.

In short, the figures demonstrate the extent to which Japanese financial markets are internationalizing. While the need to recycle Japan's current account surplus may have helped spur Japanese interest in overseas financial markets, the 1989 data suggest that a decline in that surplus will not necessarily reverse the trend. As Japanese institutions increasingly raise money abroad, continued large outbound capital flows could well be consistent with a declining balance of payments surplus. This development suggests that, should the current account outlook continue to brighten, the result need not force destructive fireworks on Wall Street.

Douglas Ostrom

Japan-Taiwan Update

Japan's economic links with Taiwan are a striking contrast to the strains that have prevailed with Beijing over the Chinese government's June 1989 suppression of prodemocracy student demonstrators. Japan-Taiwan economic ties have prospered and are deepening thanks to financial market reforms in both countries. The changes have shifted Japanese corporate attitudes toward Taiwan from that of a low-wage production base to a rapidly growing consumer and financial market.

In response to the yen's 1986-1988 rise against the dollar, Japanese corporations moved production facilities to Asian nations with lower labor costs, including Taiwan. The annual amount of direct investment in Taiwan by Japan rose rapidly from $65 million in FY 1984 to $115 million in FY 1985, $291 million in FY 1986 and $367 million the following year. In FY 1988, however, investment growth was modest as Japan added $372 million for a cumulative total of just under $1.8 billion invested as of March 31, 1989. Although exact data are not available, Japanese investment probably focused on areas of Taiwanese manufacturing strength: household appliances, electronic components (particularly computer-related), and light manufactures.

In 1988 the Taiwanese government began lifting controls on financial transactions, as Japan had done eight years earlier. Like Japan, Taiwan had developed an export-led economy in response to its relatively poor resource endowment. Also like Japan, Taiwan began to enjoy significant trade and current account surpluses, generating a large pool of funds for investment and consumption. If investment opportunities in Japan are considered limited by U.S. or European standards, so much more so have been the options in Taiwan because of its underdeveloped financial system and stringent controls on foreign exchange and overseas investment. Faced with a growing surplus of savings, the Taiwanese government began to ease controls and encourage the financial system to develop. Taipei's actions also were driven by the understanding that the country was rapidly losing its wage advantage and would have to compete through improving the value-added component of its manufactures.

Attracting foreign investment is a key part of this upward shift, mandating that financial controls be eased. Banking laws are being brought into line with the norms of Western advanced industrial nations; the stock market is being modernized and opened to foreigners; controls on outward and inward direct investment are being eased. Paralleling these changes in financial markets, Taipei is easing its grip on the flow of imports, encouraging purchases of both consumer and industrial goods. The Taiwanese quickly have moved to take advantage of this, freely buying what once were considered luxury goods from overseas.

Faced with growing frictions with the United States and uncertainty about the impact of the European Community's plan to become more fully integrated in 1992, Japanese corporations have turned greater attention to Asian neighbors. Japan's Big Four securities firms -- Nomura Securities Co., Ltd., Daiwa Securities Co., Ltd., Yamaichi Securities Co., Ltd. and Nikko Securities Co., Ltd. -- either have bought or are planning to buy a stake in Taiwanese brokerage houses. They have created mutual funds based on Taiwanese stock for Japanese investors and are exploring underwriting both government and private debt in Taiwan. Japanese banks and brokers also are willing to help Taiwanese companies expand abroad or engage in mergers and acquisitions at home. Japanese manufacturers, too, are trying to position themselves to catch the growing wave of consumer spending in Taiwan. Nissan Motor Co., Ltd., for example, is considering shipping cars and trucks from its production plants in the United States and Europe to Taiwan to meet the strong demand for foreign vehicles. Although both Nissan and Toyota Motor Corp. have stakes in local Taiwanese carbuilders, local production focuses on subcompact and commercial vehicles, not larger, more luxurious cars. Taiwan's homegrown electronics and computer industry is attracting Japanese research and production investments. Japanese department stores and consumer electronics firms hope to cater to both middle class and upscale shoppers.

In contrast to Japan's relations with China, which have been strained and highly visible, links to Taiwan have been quietly expanding. Given that Japanese businessmen see a "Pacific" century coming, it is not surprising that ties to one of the most vital and advanced of the newly industrialized Asian economies -- Taiwan -- have grown and are likely to continue to do so.

Jon Choy

Japan's Trade with Taiwan, 1985-1989

	Exports		Imports		Balance	
	Value	Change	Value	Change	Value	Change
a. in millions of yen						
1985	Y1,204,790	-15.0%	Y810,867	7.0%	Y393,923	-40.3%
1986	1,312,442	8.9	786,934	-3.0	525,508	33.4
1987	1,644,839	25.3	1,034,145	31.4	610,694	16.2
1988	1,838,998	11.8	1,119,953	8.3	719,045	17.7
1989	2,122,811	15.4	1,229,200	9.8	893,611	24.3
b. in thousands of dollars						
1985	$5,025,462	-16.0%	$3,385,531	5.7%	$1,639,931	-41.0%
1986	7,851,703	56.2	4,609,521	36.2	3,242,182	97.7
1987	11,346,272	44.5	7,128,062	54.6	4,218,210	30.1
1988	14,354,380	26.5	8,743,451	22.7	5,610,929	33.0
1989	15,424,722	7.5	8,965,473	2.5	6,459,249	15.1

Source: Ministry of Finance

Notes

Socialist Tax Reform Plan - The chairwoman of the Japan Socialist Party, Takako Doi, acknowledged February 4 that the opposition parties' final tax reform plan includes a variety of small-scale indirect taxes, such as commodity and excise taxes, a tax on admission to theaters or stadiums and a tax on electricity bills. These taxes were repealed last April at the introduction of a 3 percent consumption tax. Ms. Doi, who is campaigning for lower house elections, made this announcement to clarify the noncommunist oppositions' tax reform

RS650-2

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FY 1990 OUTLOOK FOR THE JAPANESE ECONOMY

Summary

More than three years after the Japanese economy touched bottom in late 1986, its forward progress seems unstoppable. For fiscal 1989, which ends March 31, price-adjusted gross national product is nearly certain to grow more than 4 percent and perhaps as much as 5 percent. Most Japanese analysts expect growth to be almost as high in fiscal 1990, absent any special factors. These forecasts, of course, are based on assumptions that easily could prove incorrect. In many cases alternative scenarios would imply a higher rate of growth than currently expected.

Whatever happens to the Japanese economy, Washington will be playing close attention. On Capitol Hill as well as Wall Street and Main Street, Americans have a new appreciation -- and sometimes an exaggerated view -- of how the performance of the Japanese economy affects them. As the expansion matures, the Bank of Japan may feel compelled to fine-tune Japanese policy in ways that could be interpreted in some quarters as harmful to the U.S. economy. However, the impact would be small, with both benefits and costs to the U.S. economy.

Japan's Economy in FY 1989

Economic debate in Japan was preoccupied with two issues as 1989 dawned. The first focused on the effect of tax restructuring. A mixture of tax cuts and increases were implemented in the early part of 1989, with the new 3 percent consumption tax scheduled for collection starting April 1. The second issue centered on the persistent trade imbalance with the United States and the rest of the world. While the surplus had narrowed marginally in 1988, it remained at a stubbornly high level despite the appreciation of the yen since 1985. The yen seemed to have reached a plateau in the range of Y120-Y130 to the dollar. Together, these factors suggested to many Japanese and foreign analysts that Japan would be lucky if the surplus did not begin expanding again.

Both the tax reform and the external imbalance seemed to have the potential to short-circuit Japan's economic expansion, which then was entering its second full year. Some analysts feared the new tax could create a ratchet effect on prices. They theorized that as the prices of affected goods rose to reflect the 3 percent consumption tax, merchants might take the opportunity to raise their own margins as well. Wage demands would then escalate, threatening Japan's hard-earned overall price and wage stability. In the view of Japanese analysts -- in contrast to most American experts who discount the effect of inflation on real purchases -- the resultant price increases would make consumers wary about buying, pushing the economy into a downturn.

While the effect of the tax measures was immediate, the threat posed by Japan's persistent current account surplus was more long term. In the short run Japanese firms benefited from buoyant demand in the United States and elsewhere. Over a period of years, however, Japanese experts feared that protectionist forces, especially in Japan's largest overseas market, the United States, would seize on Japan's trade figures as a rationale to restrict trade. Their apprehensions were heightened with the passage of the 1988 Omnibus Trade and Competitiveness Act. If the incoming Bush administration chose to use the new law's provisions in an aggressive manner, these experts feared, the world trading system would begin to unravel -- to Japan's severe detriment.

As is often the case, events turned out not quite as expected. The consumption tax did have a major impact but not in the way originally feared. True, prices rose significantly in April and May as the tax took hold. As economists generally had predicted, however, the effect on the overall consumer price level was only a fraction of the 3 percent levied. Furthermore, by year's end, the tax clearly had failed to generate self-sustaining price increases in the economy.

Instead, the tax created a highly skewed pattern of consumer spending. In the first three months of 1989, when the tax provisions were widely known but not yet implemented, consumers opened their pocketbooks to buy in advance of the tax. After April 1 they correspondingly reduced their inflation-adjusted spending. By the middle of the year the question was not whether the consumption tax induced inflation but rather would sluggish spending spell an early recession. At yearend, however, this fear, too, had subsided as expenditures rose comfortably above year-earlier levels.

In addition, the consumption tax became a highly contentious political issue in a very political year. Along with a variety of scandals affecting the ruling Liberal Democratic Party, the unpopularity of the tax played a major role in the unprecedented defeat the LDP suffered in the July upper house elections. The tax also was an issue in the even more important lower house elections this past February 18.

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The political uncertainty in Japan generated in part by the new tax also played a role in an unanticipated movement in the yen-dollar exchange rate: the yen dropped significantly during the year (see JEI Report No. 2B, January 12, 1990), averaging Y138=$1.00 against Y128=$1.00 in 1988. For the last half of 1989 the Japanese currency generally stayed above the Y140 level. The yen's weakness may have been a factor in an improvement in the current account surplus; by yearend the dollar-denominated imbalance was showing large drops compared to year-earlier periods, in part a consequence of some transactions being valued in cheaper yen.

Protectionist fears mounted in 1989 as Washington named Japan one of three countries under the new trade act's Super 301 provision designed to open foreign markets. However, Japan's trading partners did not erect any significant new barriers that directly affected exports in 1989. In fact, trade with the United States was, if anything, beyond initial expectations since the U.S. economy proved more robust than generally expected, with real GNP growth of 2.9 percent at the upper end of Japanese analysts' forecasts.

Government's FY 1989 Outlook in Review

A year ago last January Tokyo released its outlook for fiscal 1989, which runs from April 1, 1989 to March 31, 1990. Real GNP growth was projected to average 4 percent in FY 1989, down from the 4.9 percent the government then expected for FY 1988. (Actual GNP growth in FY 1988 came to 5.3 percent.) Domestic spending, paced by consumer purchases and plant and equipment investment, was expected to be strong enough to more than offset another year of declining net exports adjusted for inflation.

Private forecasters from banks, research organizations and elsewhere were somewhat more optimistic, expecting 4.3 percent real growth in the April 1989-March 1990 period. Moreover, they differed from the government in the details, expecting consumer spending to be less robust and investment expenditures more so. (For details, see JEI Report No. 9A, March 3, 1989.) Private forecasters agreed with their government counterparts, however, that the external sector would be a drag on the economy.

With only half the year's data compiled, the government's GNP estimate for FY 1989 already is close to realization. Even if no growth whatsoever were recorded in the last two quarters of FY 1989, growth for the year would come to 3.9 percent. The government's revised December 1989 outlook expects the economy's expansion to total 4.6 percent.

Two very recent private forecasts put the FY 1989 figure higher than does the most recent government outlook. This month Nomura Research Institute and the Japan Economic Research Center estimated 5 percent and 4.8 percent GNP growth, respectively, in FY 1989. The government figure, as well as the recent private estimates, are all larger than what the government and all but the most optimistic private forecasters initially expected. Tokyo believes, as it did last year at this time, that the external sector will pull down growth 0.7 percentage point. However, it now anticipates that consumer spending will grow only 3.2 percent rather than 4.9 percent and that private plant and equipment spending will go up 14.5 percent rather than 9.2 percent. In short, greater than expected investment will more than make up for weaker than projected consumer spending. The outcome should be higher than initially anticipated GNP growth.

Private forecasters, on balance, made the same error as the government did concerning the components of demand in FY 1989: their consensus of a year ago of a 4.6 percent increase in consumer spending was too high, and their guess of a 9.8 percent expansion in investment spending was too low. However, both estimates are closer to the probable figures than those of the government. As a result, the consensus forecast of 4.3 percent real growth probably will be closer to the mark than the government's. The consensus of private forecasters now puts growth at 4.9 percent.

In short, both government and private forecasters have underestimated the growth of GNP in FY 1989 because they were too pessimistic concerning plant and equipment spending. The greater than expected vigor with which firms have modernized and expanded capacity over the last year has led to a variety of favorable results. Higher investment demand has reduced the supply of surplus savings available for overseas capital flows. Subsequently, the demand for dollars in international currency markets has been less than it otherwise would have been, thereby somewhat counteracting the downward drift of the yen.

In addition, this unexpected investment boom has contributed directly to domestic demand. For this reason the fact that consumer spending is increasing more slowly than expected is a modest surprise. The income resulting from higher investment spending often leads to expanded consumer spending. Instead, rising corporate profits appear to be both a cause and an effect of increased plant and equipment spending, leaving consumer spending relatively unaffected.

The role of investment in the Japanese economy is interesting in part because government and private forecasters had underestimated its impact substantially in FY 1988 as well. Naturally, such history raises the possibility of a recurrence in the most recent estimates.

Outlook for FY 1990

The government prepared its economic outlook for FY 1990 in the closing days of 1989. Following past practice the figures in the outlook were incorporated into budget proposals that are now before the Diet. For the coming fiscal year Tokyo expects real economic growth to equal 4 percent, identical to last year's initial forecast (see Tables 1-3). In other ways, as well, the figures amount to a rerun of last year's. Consumer spending and plant and equipment investment are expected to provide most of the impetus for growth, with both rising substantially in excess of the projected overall growth rate. Residential construction is penciled in at a plateau following explosive growth in FY 1986 and FY 1987.

Table 1: Government's FY 1990 Economic Outlook: Real Gross National Product

(percent change)

	Actual			Estimated	Projected
	FY 1986	FY 1987	FY 1988	FY 1989	FY 1990
Real Gross National Product	2.7%	5.4%	5.3%	4.6%	4.0%
Consumer Spending	3.4	4.5	5.0	3.2	4.6
Residential Construction	11.0	25.7	5.3	0.2	0.3
Private Capital Spending	4.3	10.1	17.3	14.5	7.3

Table 2: Other Indicators

(percent change unless otherwise indicated)

	Actual			Estimated	Projected
	FY 1986	FY 1987	FY 1988	FY 1989	FY 1990
Industrial Production	-0.2%	5.9%	8.8%	5.0%	4.0%
Wholesale Prices	-9.4	-2.0	-0.7	3.5	0.6
Consumer Prices	0.0	0.5	0.8	2.7	1.6
Unemployed (in thousands)	1,710	1,700	1,500	1,450	1,450

Table 3: Japan's Balance of Payments

	Actual			Estimated	Projected
	FY 1986	FY 1987	FY 1988	FY 1989	FY 1990
Dollars (billions)					
Current Account Surplus	$94.1	$84.5	$77.3	$61.0	$56.0
Trade Surplus	101.6	94.0	95.3	81.0	78.0
Exports	211.3	233.4	267.4	276.0	293.0
Imports	109.6	139.4	172.1	195.0	215.0
Yen (trillions)					
Current Account Surplus	Y15.1	Y11.7	Y9.9	Y8.6	Y8.0
Trade Surplus	16.2	13.0	12.2	11.4	11.2

The government anticipates that both wholesale and consumer prices will be flatter in FY 1990 than they will turn out to be in FY 1989. In the current fiscal year the yen has been weaker than expected, which has tended to raise import prices and, indirectly, prices throughout the economy. The government emphasizes that its assumption of an average exchange rate of Y142.5=$1.00 for FY 1990 is just that -- an assumption rather than a forecast. Presumably, an exchange rate substantially less favorable to the yen could have modest inflationary consequences; conversely, a renewal of the yen's appreciation against the dollar could reduce the inflation rate even below the 0.6 percent rate for wholesale prices that the government currently expects over the April 1990-March 1991 period.

Both Japan's trade and current account surpluses are expected to decline in the 12 months starting in April, whether measured in yen or in dollars. The projected drop from FY 1989, however, is modest. The weak yen during the current fiscal year, which presumably will not reverse course in FY 1990, has tended to lift yen-denominated import prices and to reduce dollar-denominated export prices. The effects of these price changes have dominated the FY 1989 statistics, resulting in a J-curve short-term effect that predicts smaller surpluses from a weaker currency. In the long run import volumes tend to decline in response to higher prices, while export volumes rise because prices are lower. In FY 1990 the long-term impact may take hold, resulting in only a modest further decline in the surplus. However, if the government's figures for the upcoming fiscal year prove accurate, the cumulative effect of several years of generally subsiding imbalances will cut the surplus by 40 to 50 percent from the peak values recorded in FY 1986. For the fifth straight year real net exports are expected to decline (see Table 4), making the external sector a drag on economic growth. If the government's figures for FY 1989 and FY 1990 turn out to be correct, the current account will decline to under 2 percent of GNP in the April 1990-March 1991 period compared to a peak value of 4.5 percent in FY 1986. (Some experts believe the 2 percent level could be reached as early as FY 1989.)

Table 4: Components of Japan's Real Economic Growth

	Total Rate	Domestic		External Component
		Private	Public	
FY 1981	3.3%	1.5%	0.5%	1.2%
FY 1982	3.2	2.6	0.1	0.5
FY 1983	3.7	1.9	0.2	1.5
FY 1984	5.1	3.7	0.2	1.3
FY 1985	4.5	4.0	-0.3	0.8
FY 1986	2.7	2.8	1.3	-1.4
FY 1987	5.4	5.9	0.4	-0.9
FY 1988	5.3	6.6	0.2	-1.5
FY 1989*	4.6	n.a.	n.a.	-0.7
FY 1990**	4.0	n.a.	n.a.	-0.5

*Calculated from the government growth estimate.
**Calculated from government outlook.

Private forecasters are, as usual, more upbeat than the government about the overall pace of economic growth in the fiscal year starting April 1. On average they expect inflation-adjusted GNP to expand at a 4.4 percent pace (see Table 5). Sumitomo Trust & Banking Co., Ltd. and the Research Institute of the National Economy, with estimates of 5.2 percent and 5 percent, respectively, are the most optimistic, just as they were last year. The most pessimistic outlook belongs to Mitsubishi Research Institute, which believes growth will be 3.6 percent. The range of 1.6 percentage points in private forecasts is slightly less than last year's when it was 1.7 points.

Private forecasters are generally in agreement with the government outlook on the components of economic growth. However, like their FY 1989 forecasts a year ago, they are more optimistic than the government about plant and equipment investment but slightly less so about consumer spending. Uncharacteristically, though, the forecasters disagree on the direction of the current account imbalance. About half believe the imbalance will fall from their FY 1989 forecasts, with the range running from $43 billion (Fuji Bank, Ltd.) to $73 billion (Japan Economic Research Center) at the high end of the half that believes it will rise. Interestingly, the two extremes both base their estimates on almost the same exchange rate forecast, Y134 and Y134.8 to the dollar, respectively.

Table 5: Summary of Private Forecasts for FY 1990

(percent change unless otherwise indicated)

	Real GNP		Real Consumer Spending	Real Capital Spending	Consumer Prices	Current Account Surplus*	Y/$ Exchange Rate	Oil Prices ($/barrel)
Banks	FY 1989	FY 1990						
Sumitomo Trust & Banking Co., Ltd.	5.1%	5.2%	4.9%	10.1%	2.9%	$58.4	Y145.0	$18.5
Yasuda Trust & Banking Co., Ltd.	5.0	4.7	4.2	10.1	1.7	53.9	133.0	17.5
Dai-Ichi Kangyo Bank, Ltd.	4.8	4.6	5.0	10.7	1.4	48.1	135.0	18.3
Industrial Bank of Japan, Ltd.	5.3	4.6	4.5	9.8	1.6	58.9	133.0	16.9
Taiyo Kobe Bank, Ltd.	5.0	4.6	4.3	9.1	1.6	54.5	136.0	16.3
Bank of Tokyo, Ltd.	5.0	4.5	5.0	10.0	1.5	65.0	130.0	17.7
Fuji Bank, Ltd.	4.9	4.5	5.0	8.8	1.4	43.0	134.0	17.0
Mitsui Bank, Ltd.	5.1	4.5	4.3	10.2	1.5	57.5	131.3	18.0
Tokai Bank, Ltd.	5.0	4.5	5.0	10.0	1.5	65.0	130.0	17.7
Bank of Yokohama, Ltd.	4.3	4.4	4.6	9.2	2.0	52.7	134.0	17.0
Mitsubishi Bank, Ltd.	4.6	4.4	4.6	9.3	2.3	61.9	140.0	18.7
Mitsubishi Trust & Banking Corp.	5.1	4.4	4.0	8.4	1.8	64.1	131.0	18.2
Daiwa Bank, Ltd.	5.1	4.3	4.5	9.7	1.4	52.2	135.0	17.5
Hokkaido Takushoku Bank, Ltd.	5.0	4.3	4.6	8.9	1.5	60.7	133.3	17.7
Mitsui Trust & Banking Co., Ltd.	4.7	4.3	4.2	10.2	1.8	58.5	135.0	17.4
Sumitomo Bank, Ltd.	4.5	4.3	4.5	9.3	1.5	69.2	130.0	18.0
Toyo Trust & Banking Co., Ltd.	4.9	4.1	4.6	7.3	1.6	62.0	135.0	17.0
Chuo Trust & Banking Co., Ltd.	4.8	4.0	4.3	9.5	1.6	53.1	137.0	18.1
Nippon Credit Bank, Ltd.	4.5	4.0	4.2	8.1	1.5	60.4	140.0	17.8
Insurance Companies								
Dai-Ichi Mutual Life Insurance Co.	4.9	4.5	4.4	9.6	1.3	65.0	140.0	17.0
Meiji Mutual Life Insurance Co.	4.8	4.5	4.3	9.1	1.5	57.4	135.0	18.0
Tokio Marine & Fire Insurance Co., Ltd.	5.1	4.5	4.5	9.6	1.7	59.0	137.0	17.5
Sumitomo Life Insurance Co.	4.7	4.4	4.5	9.0	1.7	68.0	132.0	17.5
Asahi Mutual Life Insurance Co.	4.8	4.2	4.3	9.3	1.4	55.7	135.0	17.0
Trading Companies								
Sumitomo Corp.	5.0	4.7	4.8	8.4	1.8	62.3	135.0	17.5
Mitsubishi Corp.	4.8	4.6	4.5	9.6	2.0	58.0	135.0	17.5
Marubeni Corp.	4.8	4.0	4.5	7.5	2.0	56.7	135.0	17.0
Research Organizations								
Research Institute of the National Economy	5.0	5.0	5.0	10.5	2.0	56.2	135.0	18.0
Japan Economic Research Center	4.8	4.9	4.4	8.4	1.3	73.0	134.8	16.5
Kangyo Kakumaru Research Institute	5.1	4.8	4.6	8.9	1.1	60.2	140.0	17.5
Kansai Economic Research Center	5.2	4.6	4.2	8.8	3.0	62.9	136.0	17.9
Sanyo Investment Research	4.9	4.6	4.7	10.8	1.9	66.5	140.5	17.5
Daiwa Securities Research Institute	5.2	4.5	5.0	8.2	1.8	62.1	136.2	17.5
Nomura Research Institute	5.0	4.5	4.8	9.5	1.8	60.5	138.0	18.0
Yamaichi Research Institute	4.6	4.5	5.1	10.1	1.9	55.5	137.0	16.3
Cosmo Research Center	4.9	4.3	4.2	9.8	1.7	51.1	135.0	18.0
Okasan Economic Research Institute	4.8	4.3	4.0	9.4	1.7	64.4	132.5	18.0
Nikko Research Center	4.6	4.0	4.3	8.0	1.7	57.0	135.0	17.0
Mitsubishi Research Institute	4.5	3.6	4.1	8.9	1.8	58.0	142.0	18.3
Average Forecast	4.9	4.4	4.5	9.3	1.7	59.2	135.5	17.6

*In billions of dollars.

Source: Toyo Keizai Tokei Geppo

Factors Affecting the Economy in FY 1990

Forecasters, both public and private, fared fairly well in fiscal 1989. While the GNP growth rate is likely to be about 0.6 percentage point above the government's estimate, that degree of accuracy is far better than in some previous years. Private forecasters did even better, with the actual FY 1989 growth figure almost certain to lie within the range of forecasts made a year ago. In part this accuracy reflects the absence of any dramatic factors exerting a strong influence one way or the other during the fiscal year. The yen, for example, has been relatively stable. Moreover, apart from the imposition of the relatively modest 3 percent consumption tax, Tokyo attempted few fiscal or monetary initiatives.

Will the FY 1990 forecasts prove equally accurate? Most of the forecasts summarized in Table 5 were made in late November or early December. Obviously, events since then and changing expectations potentially could affect how closely the economy and the forecasts match in FY 1990. The most important recent change in the Japanese economy involves a hike in interest rates. Under its new governor, Yasushi Mieno, the Bank of Japan has signaled a willingness to tighten monetary policy significantly both to nip in the bud what it believes to be incipient inflation and to strike preemptively against an apparent recent tendency of the yen to drift lower against the dollar and other major currencies. On Christmas Day BOJ raised the official discount rate half a percentage point, to 4.25 percent, the highest level in almost four years. That move came on top of an increase in May and another in October. Furthermore, not a few analysts believe the rate will go still higher after the February 18 lower house elections.

The December increase in the discount rate had a hand in confusing Japan's financial markets in January. Bond prices were sharply lower, and the Nikkei average of stock prices also fell. Normally, such twists and turns of the stock market have little effect on the economy, but some analysts have suggested a difference this time, especially in conjunction with the discount rate hikes. The events of December and January would appear to pose a threat to the twin pillars of Japan's three-year-old economic expansion -- plant and equipment investment and consumer spending.

Investment spending is, of course, interest-sensitive; a higher charge for funds implies that fewer investment projects will clear the profitability threshold. Nomura Research Institute has estimated that a 1 percentage point rise in the discount rate reduces private plant and equipment spending 1.1 percent the first year and 3.02 percent by the second year. On this basis the December hike in the discount rate would reduce plant and equipment spending by 1.5 percent in the October-December quarter of 1991. Overall GNP would drop by 0.2 percentage point during the same period and even less in earlier quarters. Taken together, Nomura's calculations suggest that the most recent hike will probably trim a mere 0.1 point off the FY 1990 growth rate. However, if the Bank of Japan raises the discount rate again in the near future, the effects would be additive. For example, if BOJ were to raise the discount rate by the same 1.75 percentage points in FY 1990 as it did in the current fiscal year, the impact eventually would reduce GNP by 0.6 point, assuming an extrapolation of Nomura's figures.

Some analysts believe the stock market potentially could have a major effect on consumer spending. As the Nikkei average and land prices have soared in recent years, stockholders and landowners have come to feel wealthier and, in turn, have increased their spending. This effect shows up most clearly among the relatively affluent and is one reason why overall savings rates dropped in 1988 even while worker household savings rates rose, according to the latest available data. (Data for the first 10 months of 1989 show that worker household savings rates continued to rise.) Some analysts believe that high stock prices and land prices feed on each other. If so, sustained weakness in the stock market -- far beyond what has been observed to date -- could lead to a reversal of the wealth-induced drop in savings among the relatively well-off, and that implies a drop in consumer spending.

Most forecasts assume little movement during FY 1990 in the yen-dollar exchange rate. While exchange markets were relatively quiet in both 1988 and 1989, such dormancy could end abruptly. Many experts remain convinced that the long-run movement is toward a stronger yen, perhaps to the Y100=$1.00 level. In light of recent experience such a 40 percent rise in one year would be extreme but not impossible. (In FY 1986 the yen rose an average 38 percent.) Were such a hike to occur, Japanese GNP would be 1.8 percentage points lower within a year, based on an extrapolation of Nomura's figures. This prospect suggests that the Japanese economy remains highly vulnerable to exchange rate fluctuations.

The Bank of Japan's monetary policy, the drop in equity markets and the yen's possible appreciation may prove to be negative influences on the Japanese economy in FY 1990, but other factors might work the other way. For example, the yen could depreciate, giving the economy a boost equivalent to the negative influence described above. In addition, as part of the Structural Impediments Initiative talks designed to tackle the underlying macroeconomic and microeconomic causes of the huge bilateral trade imbalance, Washington has pressed Tokyo to increase its public works spending; some Japanese analysts expect that Tokyo will agree to this request. Nomura has estimated that a sustained Y1 trillion ($7.1 billion at Y140=$1.00) increase in public fixed capital formation, about a 4 percent increase, would boost GNP about 0.3 percent after a year.

More generally, the Japanese economy is entering unknown territory in FY 1990. By the reckoning of the Economic Planning Agency, Japan has had 11 economic cycles since 1951. Of these, the current expansion already is the third longest at 38 months. If the expansion continues through FY 1990, it will have lasted 51 months, longer than the 42-month "Iwato Boom" and six months shy of the famous "Izanagi Boom" that lasted from October 1965 to July 1970. Experts within the Japanese government continue to argue whether or not the Izanagi Boom met an unnatural fate at the hands of inappropriate economic policy. Not surprisingly, these experts also disagree as to whether the current expansion can go on indefinitely, especially since the Japanese economy has changed substantially during the past 20 years.

Pessimists believe that the business cycle is like a relay race, with the leading sectors changing periodically, much like relay runners passing the baton. However, like runners who drop the baton because of a slight shift in timing, the economy's expansion could be jeopardized if a sector does not take over from another at the right moment. Optimists are more likely to think of economic expansions in terms of launching a space vehicle: an initial tremendous thrust is needed to launch the rocket into space but, once there, forward motion is relatively easy to sustain.

Both examples suggest the merits of having a back-up procedure in case a runner drops the baton or a primary system fails. However, in its current expansion Japan's economy consistently has depended heavily for its growth on a single sector. Over half of the quarterly GNP growth in the past 18 months has stemmed from plant and equipment spending. Clearly, if that source fails to perform as expected, the impact on the whole economy would be substantial.

Based on current estimates, this primary system has turned out to be more powerful than anticipated in FY 1989: plant and equipment spending has soared far above initial expectations and has led Japan's economy to a near-record performance substantially above the original forecasts. The economy faces similar possibilities in FY 1990. If firms were to expand plant and equipment spending by 14.5 percent in the April 1990-March 1991 period -- the predicted rate of increase in FY 1989 -- rather than by the modest 7.3 percent expected by the government, then GNP probably would rise more than an extra percentage point based on the relationship between investment and GNP implicit in the private sector's economic forecasts. Conversely, flat investment spending would reduce the aggregate growth rate sharply compared to the published forecasts.

Already, surveys are suggesting that plant and equipment spending plans could be revised upward, again. Equipment orders, excluding ships and electric utilities, are a widely watched indicator of investment intentions. Between August and November such orders were running more than 20 percent ahead of the same period in 1988, although they dipped to a 7.2 percent year-to-year gain in December, the most recent figure available. In addition, EPA's February 1990 survey of the investment plans of big companies revealed that firms were expecting to increase their plant and equipment spending by 21 percent in FY 1989, an increase from the 17 percent hike they anticipated in November. This finding hints that the estimates in Tables 1 and 5 for plant and equipment spending may be too low. In addition, it suggests that the business sector's optimism continues to increase, with the distinct possibility that rising expectations could spill over into FY 1990 reality.

Japan's automotive industry attracts obvious interest in this regard. In late February Nihon Keizai Shimbun, the economic daily, reported that Japan's largest motor vehicle makers, Toyota Motor Corp. and Nissan Motor Co., Ltd., were planning substantial hikes in plant and equipment spending. Toyota reportedly plans a 23.1 percent increase in calendar 1990 over last year's figure; Nissan has penciled in a 53.3 percent jump for FY 1990 compared with FY 1989's outlays. Other Japanese automakers also were reported to be considering substantial increases. One motivation was said to be the growing shortage of workers, particularly in the vicinity of existing plants. This example suggests that, while the reasons could be different than in the past, investment levels could continue rising during FY 1990 in this and other important industries.

Implications for U.S.-Japan Economic Relations

Bush administration economic officials feel that the strength in plant and equipment spending in Japan could lead to an export surge, even though the short-run effect is to absorb excess Japanese savings. Apparently in response to U.S. pressure, the Ministry of International Trade and Industry reportedly is watching the investment plans of Japan's automakers and other manufacturers carefully. At times MITI has asked the companies to scale back expansion plans or scrap some capacity if new spending is planned.

Washington's concern about investment is ironic in light of what it was telling Tokyo three years ago. In 1987 Washington pressed Tokyo to energize its domestic economy. The idea was for Japan to absorb more of its own production and to increase imports. The rest, as described above, is history: the Japanese economy boomed and imports gathered speed. Washington does not appear to appreciate the fact that surplus savings in Japan have declined, since that reduction has been masked by the yen's higher value since 1985. Consequently, the flow of capital overseas has remained at almost the same rate in dollars. For the same reason the Japan-U.S. trade imbalance, while sharply lower in yen, has hardly budged in dollars. In Tokyo's view progress is substantial; in Washington's opinion, minimal.

Wall Street, which worries about whether Japanese investors will buy U.S. Treasury securities in expected amounts, feels the Japanese financial presence more than ever. American financial analysts are even paying increasing attention to Japanese monetary policy in the correct belief that it will influence Japanese investors' behavior outside their home base. Little do those on Wall Street seem to realize that, like a couple on its first date, both sides are equally nervous. Only the U.S. market is big enough to absorb the Japanese funds. If access were to be restricted or if American monetary policy turned wildly inflationary, Japanese financial institutions would have few profitable options. Should getting out prove necessary, the size of the Japanese holdings would make a quiet exit difficult.

Financial analysts on both sides of the Pacific understand their dependence on each other, as do the respective central banks. However, given that interdependence, the appropriate policy response is not necessarily clear. For example, consider the situation that faced the Bank of Japan and the Federal Reserve Board in December, when BOJ was worried about inflation in Japan and the Fed about a downturn in the U.S. economy. (West Germany and Japan were in comparable situations and acted similarly, roughly doubling the impact of their actions vis-a-vis the United States.) BOJ opted to raise interest rates and otherwise tighten money, tempting Japanese investors to keep more funds at home. To the extent this strategy worked, U.S. interest rates faced upward pressures since the supply of funds diminished in the U.S. market. However, the Fed was tempted to pursue a loose monetary strategy, with lower interest rates, in order to hold off a downturn. Had it done so vigorously at the same time BOJ was tightening policy, the flow of funds from Japan quickly could have dried up, risking turmoil in U.S. financial markets. Clearly, both BOJ and the Fed were constrained in the actions they could take; in this instance the adjustments on both sides minimized the upheaval on securities markets in the United States and Japan.

The December experience could be repeated in the near future. The forecasts summarized above suggest that the Japanese economy will remain strong; those forecasts easily could prove conservative, as they have the last three years running. As long as the U.S. economy remains healthy as well, the potential policy conflicts that confronted BOJ and the Fed in December will remain muted. However, should the U.S. economy seriously falter, the central banks of both countries could face a severe dilemma.

If the Japanese expansion continues at its current pace, BOJ will feel increasingly compelled to tighten money. The Fed would feel renewed pressure to adopt a looser U.S. policy, especially in an election year, should the U.S.

economy show signs of weakening. If pursued unilaterally, the Fed's actions would push down interest rates in the United States and tend to lower them in Japan as well. However, a BOJ move to raise Japanese rates would result in some spillover to American financial markets and tend to nudge rates up here. In other words, if the central banks acted simultaneously they would be pushing interest rates in opposite directions in both countries.

For BOJ the choice is not simply whether to help the Fed. As Japan plays a larger role in international markets, preventing inflation in Japan benefits anyone anywhere holding yen-denominated securities. In addition, rightly or wrongly, BOJ believes that low inflation is a key to continued consumer confidence in Japan. Should consumer confidence falter, economic growth would decline. If that were to happen, Washington and Tokyo would return to the situation as it existed in 1987 when Japan's economy appeared to be stagnating and Washington urged it to expand. Hence, BOJ sees little reason to reverse its tight money policy.

Interest Rates, Capital Flows and Exchange Rates

Of course, should Japan's economy remain strong and that of the United States weaken, the Fed and BOJ could both take their preferred actions provided they took care not to scare financial markets. The result would be lower interest rates here and higher ones in Japan, with both changes offset to some extent by opposite forces from the other country. The diminished interest rate gap would tend to reduce the demand for dollars on the part of Japanese investors, and thus drive down the dollar against the yen. This, in turn, would reduce the bilateral and worldwide trade imbalances of both the United States and Japan.

The BOJ-Fed policy mix described above is more likely in the coming year than it has been in the past. The longer the Japanese expansion continues, the more BOJ worries about inflation. The Federal Reserve Board is not unconcerned about inflation but has to give the possibility of an economic downturn considerable weight in its policy formulation. The Fed has indicated by its past actions that it would move quickly in the face of recessionary forces. Should the BOJ tighten -- and the Fed loosen -- their respective monetary policies, the value of the yen would rise against the dollar, as noted. For this reason, the yen's recent weakness does not necessarily point to its future direction. Since this situation presupposes a vigorous economic expansion, the shift toward domestic-led growth and away from exports might be more pronounced than shown in the government and the private forecasts summarized above.

How a combination of tighter monetary policy in Japan and a stronger yen would play in Washington remains to be seen. The United States would certainly welcome a reduction in the trade imbalance. However, Tokyo's actions would also nudge U.S. interest rates higher than they otherwise would be and risk disruption in financial markets. In addition, the dollar-denominated reduction in the trade imbalance would be small since the yen's appreciation once again would obscure the movement that would occur in the yen-denominated balance.

Prospects for Japan's Overseas Capital Flows

To the extent that economic influence flows east across the Pacific, the impact of economic developments in Japan are fairly clear through the end of FY

1990. With continued economic growth and the possibility of greater public and private demand for Japanese savings, Japan's surplus in savings is unlikely to increase significantly. Table 6 gives details of this argument. During the economic expansion that began in late FY 1986, personal savings have grown; however, the uses of savings within the household sector for housing and other investments have risen faster, resulting in a reduction in the household surplus. The corporate imbalance has widened dramatically as plant and equipment spending has surged. Despite a shrinking public-sector deficit that turned to surplus in FY 1988, spending in the previous two fiscal years by households and corporations significantly reduced the availability of funds for financing overseas deficits (excess demand by overseas users of Japanese capital). Nomura, based on a forecast that is typical of those summarized in Table 5, believes this trend has continued in FY 1989 but that it will end in FY 1990 as the aggregate overseas deficit stabilizes.

Table 6: Investment-Saving Balance

(trillions of yen)

	Actual			Estimated	Projected
	FY 1986	FY 1987	FY 1988	FY 1989	FY 1990
Household Sector	Y32.6	Y28.9	Y25.1	Y27.6	Y29.7
Corporate Sector	-2.0	-11.4	-15.4	-21.0	-25.0
Public Sector	-13.5	-3.6	2.0	3.1	3.9
Foreign Sector	-15.1	-11.7	-9.9	-8.1	-8.3
Financial Sector	-2.0	-2.2	-1.8	-1.5	-0.3

Notes: Figures for FY 1989 and FY 1990 are estimates and projections of Nomura Research Institute.

A negative figure indicates that a sector is a net user of Japanese savings. Therefore, balance of payments surpluses correspond to negative figures in the table.

Source: Nomura Research Institute

If, for the reasons outlined above, Japanese monetary policy tightens significantly vis-a-vis U.S. actions, the yen could be substantially stronger than assumed in Nomura's forecast. Such a development would tend to induce Japanese capital to stay at home, reducing the outflow in yen but tending to raise the amount as measured in dollars. In other words, the high yen scenario described above would put into action a replay of what happened to capital flows between 1985 and 1989.

In short, the flow of funds from Japan to the rest of the world depends on the Japanese economy. All of the factors mentioned above will influence that flow. A stronger yen could increase the flow as measured in dollars, even if it reduced it as measured in yen. Higher investment, whether by firms in the form of plant and equipment spending or by the government on public works, would reduce the flow. A higher personal savings rate would increase the flow. On balance, the best guess is that changes in overseas capital movements will be modest, as indicated in Table 6, with a chance that the flow as measured in yen could be significantly smaller if the Bank of Japan and the Federal Reserve Board act to tighten and loosen money, respectively.

Conclusion

As Japan enters the fourth full fiscal year of its economic expansion, it is plowing new ground. Not for a generation has economic growth in Japan been so consistently strong for so long. As a result, forecasting the coming year involves even more than the usual amount of guesswork. As usual, Japanese forecasters in and out of government see little dramatic change. However, as Japan approaches both full employment of its labor force and full capacity of its factories, the dangers and the uncertainties of running full bore obviously increase.

The Bank of Japan understands the risks. As it wrestles with ways to offset them, BOJ necessarily will run a hazard of a different sort: attempting policy coordination with the Federal Reserve Board should the American economy weaken significantly at the same time the Japanese economy appears in danger of overheating. BOJ and the Fed could avoid these problems by, for example, carefully raising rates in Japan and reducing them in the United States, which also would have the salubrious effect of a smaller trade imbalance. However, there is little prospect that a year from now the U.S.-Japan relationship will be drained of its current tension. Reducing the trade imbalance could exacerbate other problems. Like children playing on a see-saw, Washington and Tokyo could start by learning the limitations of the instruments they are using.

For further information, contact Douglas Ostrom.

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The views expressed in this report are those of the author and do not necessarily represent those of the Japan Economic Institute.

APPENDIX

Japan's Real Gross National Product at Constant (1980) Prices

(in billions of yen, seasonally adjusted, quarterly totals and rates of growth at annual rates)

	FY 1987	FY 1988	October-December 1988	January-March 1989	April-June 1989	July-September 1989
Gross National Product	Y318,109.2 (5.4%)	Y334,968.8 (5.3%)	Y337,203.3 (4.7%)	Y343,155.4 (7.2%)	Y340,561.8 (-3.0%)	Y350,520.9 (12.2%)
Personal Consumption Spending	176,556.3 (4.5%)	185,317.8 (5.0%)	185,932.0 (3.0%)	188,458.9 (5.5%)	186,600.8 (-3.9%)	190,316.3 (8.2%)
Private Residential Construction	19,653.9 (25.7%)	20,686.8 (5.3%)	21,241.7 (12.1%)	21,341.2 (1.9%)	20,855.0 (-8.8%)	21,340.1 (9.6%)
Private Fixed Nonresidential Investment	61,897.9 (10.1%)	72,617.1 (17.3%)	73,117.5 (13.2%)	77,820.6 (28.3%)	78,320.0 (2.6%)	84,033.5 (32.5%)
Change in Business Inventories	1,618.0 (*)	2,080.6 (*)	2,362.2 (*)	1,080.4 (*)	2,463.2 (*)	1,815.1 (*)
Government Current Expenditures	28,697.2 (-0.6%)	29,341.5 (2.2%)	29,461.4 (3.3%)	29,647.9 (2.6%)	29,650.4 (0.0%)	29,727.0 (1.0%)
Government Fixed Investment	24,335.8 (9.4%)	24,621.6 (1.2%)	24,542.9 (0.6%)	24,674.3 (2.2%)	24,540.4 (-2.2%)	24,214.0 (-5.2%)
Change in Government Inventories	46.1 (*)	-185.0 (*)	-879.0 (*)	261.2 (*)	371.8 (*)	63.4 (*)
Net External Sector	5,304.1 (-33.7%)	488.4 (-90.8%)	1,424.7 (235.3%)	-129.0 (*)	-2,239.8 (*)	-988.5 (*)
Exports of Goods and Services and Factor Income Received	55,507.1 (5.4%)	61,457.7 (10.7%)	62,093.4 (4.0%)	66,337.7 (30.3%)	65,824.7 (-3.1%)	69,636.2 (25.3%)
Imports of Goods and Services and Factor Income Paid	50,203.0 (12.4%)	60,969.3 (21.4%)	60,668.7 (2.2%)	66,466.7 (44.1%)	68,064.5 (10.0%)	70,624.7 (15.9%)

*Cannot be calculated or meaningless.

Source: Economic Planning Agency

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JAPAN · ECONOMIC · INSTITUTE

JEI REPORT

A Two-Part Report: A and B

NO. 8B
February 23, 1990

IN THIS ISSUE:

LDP Retains Government Control 1

Implementation Of Large Retail Store Law To Be Improved 4

Drexel Failure Fails To Faze Japanese 6

Surging Tourism Lifts Japan's Services Deficit .. 7

Indonesian Telecommunications Project Turns Political 9

Notes: Export Controls; Driftnet Fishing 11

LDP Retains Government Control

Japan's ruling Liberal Democratic Party succeeded in maintaining its 35-year domination of Japanese politics by securing a solid majority in the February 18 lower house elections. Defying some doomsayers who had predicted LDP losses that might necessitate formation of a ruling party-opposition party coalition, the Liberal Democrats captured 275 seats; conservative independents who subsequently aligned with the ruling party upped the LDP's official tally to 286 (see Tables 1-3). This figure is well in excess of the minimum 271 seats the party needed to retain control of all committees in the 512-seat House of Representatives (see JEI Report No. 5B, February 2, 1990). The LDP captured approximately 47 percent of the popular vote, reportedly only slightly below the percentage won in July 1986 when the ruling party gained a record 300 lower house seats.

Since the lower house selects the prime minister, the LDP victory assures continuity in government. However, the election returns do not necessarily assure political stability. Although the opposition parties together could not usurp the ruling party's controlling majority -- some parties, in fact, lost seats -- the Japan Socialist Party was able to increase its representation from 85 seats to 141 seats. This follows the JSP's unprecedented gains in the July 1989 upper house elections, a victory that served to undermine the LDP's controlling majority in that chamber (see JEI Report No. 32A, August 18, 1989). If the JSP can orchestrate a united opposition in the upper house, the ruling party, despite its apparent renewed strength, may be forced to concede to certain opposition party demands to gain passage of key legislation.

Some political analysts interpret the JSP's gains in the February 18 contests as the voting public's signal to the LDP that all is not completely forgiven, that the ruling party warrants only a qualified endorsement. "The votes that went to the Socialist Party are checking votes against the LDP," Yohei Kono, a senior LDP member was quoted as saying. Gerald Curtis, a Columbia University professor, concurred that the elections represented a "vote of confidence that the LDP is the best thing [the Japanese people] can get, given the options they were offered." He also was quoted as saying that "Japanese voters looked at the prospect of an opposition government and said, 'No thanks,' or at least, 'Not yet.'"

Local issues and "pork barrel" politics in general appeared to have a stronger influence on voters' selection of their lower house representatives than national issues, according to several pundits. Specifically, the Recruit Co., Ltd. influence-peddling scandal, which toppled the administration of former Prime Minister Noboru Takeshita and contributed to the ruling party's defeat in the July upper house elections, did not appear to be of as much concern this time to voters. Virtually all of the senior LDP members who in some way were tainted by the scandal -- including Mr. Takeshita, former Finance Minister Kiichi Miyazawa, former LDP secretary general Shintaro Abe, former Prime Minister Yasuhiro Nakasone and former chief cabinet secretary Takao Fujinami, who is under indictment in the affair -- were returned to office. Mr. Nakasone, who faced what was described as one of the toughest races of his 16-term career, declared that the elections "purged" himself and others caught up in the Recruit web. "The general election is the highest judgment of the people . . . so I think the case has been closed," he said.

However, the electorate was not as forgiving when it came to the 3 percent consumption tax, which went into effect last April. Sadanori Yamanaka, who as chairman of the LDP tax committee played a key role in developing the tax, was voted out of office. Three other ruling party members active in the tax reform debate -- Tatsuo Murayama, former finance minister; Takeshi Moda, vice chairman of the LDP tax committee; and Yuji Tsushima, secretary general of the LDP tax committee -- were returned to the Diet but with considerably less support than they had received in the 1986 elections. The ruling party leadership no doubt interpreted these losses as a painful reminder that the electorate expects to see meaningful action on tax reform when the Diet resumes legislative activity, probably in early March.

Despite the charisma of JSP chairwoman Takako Doi and her nationwide campaigning -- which galvanized the female vote to an extent not known in recent Japanese political history -- Japanese voters in the final analysis apparently viewed with considerable apprehension Ms. Doi's inability to forge a consensus within her own party as well as with the other opposition parties on key foreign policy issues (see JEI Report No. 6B, February 9, 1990). When her

Table 1: February 18, 1990 Lower House Election Results

Party	Seats After July 1986 Elections	Seats When Diet Dissolved January 1990	Seats After February 1990 Elections
Liberal Democratic Party	300	295	286
Japan Socialist Party	85	83	141
Komeito	56	55	46
Japan Communist Party	26	27	16
Democratic Socialist Party	26	26	14
United Social Democratic Party	4	4	4
New Liberal Club	6	0	0
Progressive Party	0	1	1
Independents	9	4	4
Total	512	495*	512

*17 seats were vacant at the time of the February 18 elections.

Table 2: Status of Winning Lower House Candidates

Party	Incumbents	Former Office Holders	New	Total
Liberal Democratic Party	228	5	53	286
Japan Socialist Party	65	16	60	141
Komeito	35	0	11	46
Japan Communist Party	10	2	4	16
Democratic Socialist Party	8	3	3	14
United Social Democratic Party	4	0	0	4
Progressive Party	1	0	0	1
Independents	2	0	2	4
Total	353	26	133	512

Table 3: Current Upper House Party Alignment

Party	Seats
Liberal Democratic Party	109
Japan Socialist Party	73
Komeito	20
Japan Communist Party	14
Democratic Socialist Party	10
United Social Democratic Party	0
Progressive Party	0
Rengo	12
Minor Parties	9
Independents	4
Total	251*

*One seat is vacant.

party ousted the LDP from leadership of the upper house last summer, the jubilant JSP leader proclaimed that the "mountain had moved [and would move again during the lower house elections]." Following her party's February 18 performance, however, Ms. Doi was quoted as acknowledging that the "mountain was very heavy."

The strength of the LDP's win would appear to improve Prime Minister Toshiki Kaifu's chances of retaining his post. Speculation was rampant during the campaign that the former education minister, who is a member of a small LDP faction headed by Toshio Komoto, would be forced out of office in favor of Mr. Abe or another party elder (see JEI Report No. 5B, February 2, 1990). Following the elections, however, Mr. Abe confirmed that it was his impression that Mr. Kaifu would continue to lead the ruling party and, therefore, the government. The fact that some incumbent LDP members were defeated by younger ruling party challengers may suggest that voters favor a generational change in LDP leadership. And Mr. Kaifu, 59, projects a youthful image untainted by major faction, "back room" politicking.

Should U.S.-Japan relations take a turn for the worse, however, pressures again may build to replace the current prime minister with Mr. Abe, who is a former foreign minister, or Mr. Miyazawa, who also is experienced in diplomacy. For the moment, Mr. Kaifu no doubt is breathing a sigh of relief and basking in his party's victory.

Barbara Wanner

Implementation Of Large Retail Store Law To Be Improved

As the third round of talks on the Structural Impediments Initiative approaches, Japan's distribution system is surfacing as a top agenda item. U.S. Ambassador to Japan Michael Armacost, addressing a seminar sponsored by Kansai business groups February 8, said that American trade officials during the February 22-23 SII meetings would focus on the Large Retail Store Law, which they view as a barrier to the entrance of foreign-made goods into the Japanese market. Many newspapers reported that he said Tokyo should spare no effort to reform the law, which regulates the opening of major retail operations, or, better yet, abolish it entirely. The ambassador later clarified that he replaced the sentence "abolish it entirely" in his speech with "provide an equal opportunity for American companies." He reportedly made the change in view of the potential impact of his comments on the February 18 lower house elections -- in particular, its possible effect on the Liberal Democratic Party's showing. Whether the U.S. request be to abolish the law or not, the topic is certain to be a central matter of discussion in the upcoming SII talks.

Seemingly responding to the ambassador's remarks, Prime Minister Toshiki Kaifu said February 9 that the government is studying specific measures to ease implementation of the Large Retail Store Law. Mr. Kaifu told reporters that Japan has no plans to revise the law itself; instead, the legislation will be applied more flexibly, mainly by setting a time limit for processing applications by department stores, supermarket operators and discount chains interested in opening new stores. A Ministry of International Trade and Industry advisory group outlined these changes last June (see JEI Report No. 24B, June 23, 1989). Analysts suggest Mr. Kaifu made the commitment to relax implementation particularly American, M&A deals. Japanese banks anted up more than $2 billion for Campeau Corp.'s ill-fated $6.6 billion purchase of Federated Stores Inc. Japanese banks also have participated heavily in highly visible megadeals, such as the buyout of RJR Nabisco Inc. and the merger between Time Inc. and Warner Communications Inc. The failure of the top junk bond firm is likened to the last nail in the coffin of an era of uninhibited M&A activity. Recent sharp declines in the junk bond market have led American and foreign investors to adopt tougher standards for evaluating M&A deals. While this will make the current M&A market downturn sharper, it may help stabilize the business over the long run.

In the meantime, Japanese firms continue to learn the ropes of the fast-moving and complex M&A market. Beginning in 1986 several Japanese companies forged ties with American M&A specialists: Sumitomo Bank, Ltd. put $500 million into Goldman, Sachs & Co.; Nippon Life Insurance Co. invested $508 million in Shearson Lehman Hutton Inc.; Nomura Securities Co., Ltd. bought a one-fifth stake in Wasserstein, Perella & Co.; Nikko Securities Co., Ltd. purchased a similar share of the Blackstone Group; Yamaichi Securities Co., Ltd. put $25 million into Lodestar Partners; Long-term Credit Bank of Japan, Ltd. has invested in Peers & Co.; and Fuji Bank, Ltd. formed a joint venture with James D. Wolfensohn Inc. Mitsui Bank, Ltd. is the latest to join the M&A parade, announcing in January that it was contributing $25 million to a $250 million fund managed by the Carlyle Group.

These tie-ups have had very uneven results: Sumitomo and Goldman, Sachs are prevented from doing joint business by the Federal Reserve Board, and Nippon Life's investment in Shearson has declined, on paper, by more than $350 million. There also are reports of friction between some of the partners, an unsurprising reaction since some of the Japanese firms are trying to build up independent M&A units. Overall, however, there is agreement that the tie-ups serve the interests of both partners in the short and the long term. Drexel's bankruptcy is a pothole -- not a blackhole -- in Japan's path to a major role in the global M&A market.

Jon Choy

Surging Tourism Lifts Japan's Services Deficit

What country has the world's largest international deficit in travel services? The new champion globe trotter will come as no surprise to Americans, particularly those who have made a recent trip to Hawaii or to other well-known tourist destinations in the United States. In 1989 Japan appeared to have the largest international deficit in travel income, for the first time taking the lead from the West Germans, according to Japanese press reports.

Economists who have studied international travel patterns were not surprised. At least since the advent of flexible exchange rates in the early 1970s, tourism has proved to be one of the international activities most responsive to currency movements. Just as Americans flocked to Europe in the early 1980s in response to a dollar that seemed to buy far more than it had a few years earlier, Japanese tourists have found new reasons since the yen began appreciating in 1985 to hop on a plane at Narita or another Japanese airport and head overseas. Japan's travel-related deficit in 1989 of $19.3 billion was enough to offset about one-quarter of its trade surplus (see Table). The Japanese took more than 9.6 million trips abroad last year, records show.

Japan's Services Trade, 1985-89

(net balance in millions of dollars, IMF value basis)

	1985	1986	1987	1988	1989*
Travel	$-3,677	$-5,766	$-8,663	$-15,789	$-19,327
Passenger Fares, Freight and Other Transportation	-2,649	-2,537	-6,106	-7,436	-8,320
Investment Income	6,840	9,473	16,670	21,032	23,434
Other	-5,679	-6,102	-7,603	-9,070	-11,712
Total Services	-5,165	-4,932	-5,702	-11,263	-15,925

*Preliminary

Source: Bank of Japan

Besides helping to reduce Japan's overall current account surplus, the increase in foreign travel has had other effects. Following in the footsteps of Americans a generation before them who spawned an empire of Holiday Inns and other American-type facilities abroad, Japanese tourists have created a demand for hotels and other Japanese-oriented amenities in the top tourist destinations. In Hawaii the recent transfer of the local 7-11 convenience stores to Japanese control was said to be, in part, a response to Japanese tourists who found the indigenous stores unlike the "real thing" in Japan. (7-11 stores in Japan, originally an offshoot of the American chain, have evolved independently in recent years, although to the casual American tourist they still appear to be a reasonable facsimile of the U.S. version.)

The surge in tourism has buried, at least for the moment, concern prominent several years ago regarding the services component of Japan's current account. At the time many experts felt that rising interest, dividend and other income from direct and portfolio investment would offset a significant portion of any improvement in the trade balance resulting from the stronger yen. Just as surpluses on overseas investment income masked for a while the deterioration of the U.S. balance of payments in the 1980s, this argument went, the decline in Japan's services deficit -- a result of higher investment income -- would offset any reduction in its trade surplus.

Investment income has, in fact, surged since 1985 as the yen has appreciated. Japanese tourists were not alone in discovering the price advantages of overseas locations; Japanese manufacturers rushed to establish facilities in North America and Asia and elsewhere to maintain their competitiveness. Portfolio investment rose even more. In 1989 the surplus in investment income remained larger than the deficit in travel. However, the deficits in the remaining services accounts also grew, resulting in an increase in the overall services deficit, not the decrease that was widely forecast. The resultant services deficit was the main reason that Japan's current account surplus was 26 percent smaller than the trade surplus in 1989. (For details of the overall 1989 current account, see JEI Report No. 7B, February 16, 1990.) Today, few are willing to state with much confidence whether travel and other trade in services will continue to outpace investment income. However, with even fewer believing that Japanese tourists have had their fill of foreign travel, growing deficits in international travel expenditures virtually are guaranteed.

Douglas Ostrom

Indonesian Telecommunications Project Turns Political

International competition for a big Indonesian telecommunications contract that reportedly has been narrowed to bids from two rivals -- American Telephone and Telegraph Co. and NEC Corp. -- has created a tense political situation for Jakarta. The selection of one firm over the other may bring cries of foul from the loser and dampen the relations of Jakarta and that company's government. On the one side are trade and security relationships with the United States; on the other are foreign aid and investment relationships with Japan. Both are vital to Indonesia.

The Bush administration's reaction to rumors that Tokyo had applied political pressure to gain the contract for NEC has been quick and intense as American officials attempted to show that Washington will stick up for American businesses overseas if they are not treated fairly. The rumors have fueled American concerns that Japan does not "play on a level field" and have sparked calls in Washington for increased competitiveness. Deputy Secretary of State Lawrence Eagleburger said in a November 30, 1989 speech that State will do more to promote U.S. economic interests overseas. He added that Secretary of State James Baker hopes to boost counseling by government officials to help American businesses operate abroad and to promote exports. In advising American companies about the types of assistance they can expect from State, Mr. Eagleburger announced a "Bill of Rights for American Business," in which one provision asserts Americans "have a right to the active promotion of U.S. firms in international bids. . . ."

The Second Digital Telephone System project, part of Indonesia's national development plan, is valued at around $300 million. The company that installs this phase, however, also is expected to be awarded the remainder of an estimated $2 billion telecommunications project. The tenders are for installation of digital central office switching equipment that can handle 350,000 lines.

The field of five foreign competitors reportedly narrowed by February 12 to just two -- AT&T and NEC. The U.S. Embassy in Jakarta reportedly told Washington that Tokyo was trying to influence the outcome of the deal, perhaps through references to Japan's $9.8 billion direct investment position in Indonesia as of March 31, 1989 and its $985 million in foreign aid in 1988 alone. Japan is the top aid donor to Indonesia (see Tables 1-4). To counter the purported influence of Tokyo, President Bush sent a letter February 2 to President Suharto asking Indonesia to consider the AT&T bid, according to the Washington Post. State Department officials, however, would not comment to JEI whether Mr. Bush or Secretary of State James Baker had tried to influence Jakarta's decision.

Table 1: Japanese and U.S. Trade with Indonesia, 1985-89

(in millions of dollars; exports f.o.b./f.a.s., imports c.i.f.)

	Japan			United States		
Year	Exports	Imports	Balance	Exports	Imports	Balance
1985	$2,173	$10,119	$-7,947	$795	$4,933	$-4,138
1986	2,662	7,311	-4,649	946	3,675	-2,730
1987	2,990	8,427	-5,437	767	3,719	-2,952
1988	3,054	9,497	-6,443	1,056	3,494	-2,438
1989	3,301	11,015	-7,714	1,256	3,543	-2,286

Sources: Ministry of Finance and Department of Commerce

Table 2: Japanese and U.S. Official Development Assistance To Indonesia, 1984-88

(in millions of dollars, net disbursement basis)

	1984	1985	1986	1987	1988
Japan	$168	$161	$161	$707	$985
United States	61	43	46	36	22

Sources: Ministry of Foreign Affairs and Agency for International Development

Table 3: Japan's Cumulative Direct Investment in Indonesia, FY 1984-FY 1988

(in millions of dollars, gross announced value)

FY 1984	FY 1985	FY 1986	FY 1987	FY 1988
$8,015	$8,423	$8,673	$9,218	$9,804

Source: Ministry of Finance

Table 4: U.S. Cumulative Direct Investment in Indonesia, 1984-88

(in millions of dollars, net book value)

1984	1985	1986	1987	1988
$4,093	$4,475	$3,217	$3,050	$3,006

Source: Department of Commerce

Officially, neither Washington nor Tokyo concedes having lobbied Jakarta to influence the award of the telecommunications contract. The State Department wants to see the contract awarded on a fair basis, founded on the technical and the financial packages offered, an official noted. An Indonesian Embassy official in Washington similarly asserted that in awarding international contracts ". . . a thorough study of all aspects combined with rational, just and fair consideration have always been the government's primary guidance. . . . We do not allow either economic bias or political pressure to cloud our judgment." No threats of retaliation, such as reduced trade or aid, have been made by either the United States or Japan, various sources implied.

The furor over the telecommunications contract, if reported accurately, has shown the resolve of the United States to support its businesses overseas and its willingness to counter "unfair" advantages taken by foreign governments, be they Japanese or other. The competition comes at a time of broader economic rivalry and generally hostile feelings among those concerned about the causes of the stubborn U.S. trade deficit with Japan. Taking a strong stance may win the president the domestic support he needs to create an agenda to tackle the trade deficit.

Gretchen Green

Notes

Export Controls - Despite the relaxation in East-West tensions and building momentum for political and economic reform throughout the Soviet bloc, the Cocom (Coordinating Committee on Multilateral Export Controls) meeting in Paris February 14-15 found members proceeding with caution in considering the extent to which export controls should be relaxed on sophisticated technologies destined for Eastern European markets. For the past 40 years this 17-nation body has sought to safeguard strategic technology from countries deemed hostile to the Western alliance.

According to U.S. sources, member nations agreed on certain procedural reforms and an "intensified program" for modernizing the Cocom control list. Specifically, Cocom participants agreed to cut the processing of export licenses from a maximum of 12 weeks to 8 weeks. In terms of "modernizing" the Cocom control list, State Department spokesman Richard Boucher said that an agreement was reached on a U.S. proposal to focus liberalization in three product areas: telecommunications equipment, computers and machine tools. No products were struck from the list. "Technical experts will meet to complete [this review] by the end of May," Mr. Boucher stated. "We may identify additional product categories for priority attention later."

This statement would appear to downplay numerous press reports concerning an alleged agreement in principle to allow reformist Eastern European countries the same access level granted China in the aforementioned product categories. In response, a U.S. government source would say only that a number of liberalization approaches are under consideration. In his statement Mr. Boucher noted that Cocom members welcomed overtures from various Soviet bloc countries to protect Western technology but cautioned that favorable treatment is contingent on their adoption of "credible safeguard measures."

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JEI

REPORT

A Two-Part Report: A and B

NO. 9A March 2, 1990

AMERICAN AND JAPANESE POLLS ON THE BILATERAL RELATIONSHIP: TRENDS AND IMPLICATIONS

Summary

Recent polls in both Japan and the United States indicate that, while there is still a reservoir of goodwill between the two countries, popular attitudes on both sides of the Pacific are growing more critical. The reasons for the rising tension may be associated with the uncertainty that Japanese and Americans feel about the future of bilateral relations. As Japan's economic strength increases -- and as the U.S. economic position appears to waver -- the two countries' respective citizenry tries to assess what these changes might mean to them directly and the rapidly changing international system indirectly. The public's attitudes, in turn, can affect the actions of politicians. An examination of the content of some recent polls will preface a review of the possible implications of deteriorating popular attitudes for the future of bilateral relations.

Introduction

It has become almost commonplace to speak of "mounting tensions" between the United States and Japan. The rhetoric between Washington and Tokyo has been especially heated during recent years. In 1989 both governments embraced official positions that reflected their concern about these tensions. Washington cited Japan as a priority country under the Super 301 provision of the 1988 Omnibus Trade and Competitiveness Act, while Tokyo officially recognized the increasing tensions in the bilateral relationship in its annual diplomatic blue book. Despite these developments, policymakers in both countries continue to insist that the two nations are among the world's closest allies. Thus, the actions and the language of national leaders send mixed signals.

It has long been a matter of debate whether the statements of policymakers truly reflect national attitudes. How close do Americans perceive the U.S.-Japan alliance to be? Similarly, what is the attitude of the average Japanese citizen regarding the United States? Extensive polls in both countries have addressed these kinds of questions. Not surprisingly, a review of recent polls reveals somewhat contradictory responses. Some reflect a broadly positive view of bilateral relations, with respondents on both sides likely to say they have some warm feelings toward the other. Other polls indicate much less friendliness. For example, some Japanese surveys have reflected negative attitudes not only about U.S. policies but about American traits as well. A number of U.S. pollsters have concluded that Americans are more worried about the Japanese economic "threat" than the Soviet Union's military might.

These latter polls have generated considerable concern in policymaking circles. While it would be premature to conclude that bilateral relations are irrevocably set on a downward course, it is hardly an overstatement to suggest that they are under increasing stress. As Japan's economic strength continues to grow -- and as Americans believe that this growth often occurs at their expense -- tension has mounted in this country. Meanwhile, these is a feeling in Japan that U.S. policymakers are making Japan a scapegoat for Washington's domestic economic problems rather than embracing the kinds of difficult policy choices necessary to restore U.S. competitiveness.

Over time the trend from such polls is probably toward the negative. While it is not difficult to find evidence of positive attitudes, most multiyear polls reveal that feelings of goodwill are declining as time passes. The questions themselves seem to be phrased in increasingly confrontational terms. This may be both cause and effect in the determination of public attitudes.

Some Methodological Considerations

The mixed nature of polling data probably occurs for two reasons. The first is methodological. Researchers are quite aware that the way a question is asked influences -- and sometimes determines -- the answer. Related to the choice of words used in a question is its degree of specificity. That is, an examination of poll data reveals that when people are asked a very general question -- along the lines of "How would you evaluate the state of U.S.-Japan relations?" -- the answers are generally positive. When people are faced with more specific questions (for example, regarding single issues like Japanese investment in the United States), responses are sometimes more negative. This could be because people are more reluctant to characterize a country in sweepingly negative terms; it also could be because specific questions bring to mind specific grievances.

It also is important in reviewing the results of polls to remember that nearly all of them are representative of public views and not necessarily the views of decisionmaking elites. While decisionmakers may turn to popular opinion to support their policies, they equally may shape those attitudes through subtle and not-so-subtle actions. Elites obviously have more influence than the overall population in affecting the state of bilateral relations. Thus, the

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results of a 1986 Gallup Poll commissioned by the Chicago Council on Foreign Relations assumes considerable significance: 98 percent of the "leaders" compared to 78 percent of the public said the United States had a "vital interest" in Japan. And even within the hierarchy one person in a key position can have an enormous impact on policy formation -- as evidenced by the influence George Bush has had in shaping U.S. policy toward China (despite substantial opposing views not only in the overall population but also within Congress).

An examination of popular attitudes indicates nothing about how such attitudes are formed. Effective elites can shape popular opinions. How decision-makers interact with the media and the role of the media itself have a crucial hand in forming national attitudes. Particularly as far as the U.S.-Japan relationship is concerned, the media in both countries have tended to highlight the dramatic and confrontational elements of the relationship. In the United States, for example, press accounts of such actions as the Japanese purchase of Columbia Pictures may have been highly influential in affecting American attitudes regarding Japanese investment in this country. Similarly, the Japanese press tends to portray bilateral economic relations in terms of a panoply of U.S. demands rather than a set of ongoing economic negotiations. To the extent that such issues are portrayed in a negative fashion, they may be instrumental in increasing negative popular attitudes.

Another caution about polls is that they do not reflect the intensity of respondents' feelings. For instance, 50 percent of the population may choose a negative response, but the level of negative feeling cannot always be derived from the categories in the poll. Too, people may have especially negative attitudes regarding a particular issue -- for example, rice imports in Japan or foreign direct investment in the United States -- but generally good feelings about overall relations. Conversely, in some cases the negative feelings associated with one particular issue may spill over into overall attitudes (perhaps depending on whether a respondent lives in an economically hard-hit area like the U.S. "rust belt").

Overall Impressions: Friendly But Wavering

One of the most striking aspects of the postwar bilateral relationship has been the degree to which -- despite the many areas of tensions -- U.S.-Japan relations have been perceived as friendly. Indeed, most contemporary research reveals that the majority of Americans and Japanese continue to perceive overall relations as warm or "somewhat" warm. Interestingly, observers of U.S.-Japan relations have noted that despite the attention given to "Japan bashing" in the United States, overall U.S. sentiment toward Japan has ranked consistently warmer than Japanese sentiment toward the United States. For example, in one of a series of polls by the New York Times/CBS News and the Tokyo Broadcasting System, people were asked:

> How would you describe relations between Japan and the United States today? Would you say relations are very friendly, somewhat friendly, somewhat unfriendly, or very unfriendly?

	1989	1988	1987	1986	1985
United States					
Very Friendly	17%	14%	13%	22%	23%
Somewhat Friendly	62	59	59	63	65

Somewhat Unfriendly	10	14	17	7	6
Very Unfriendly	2	3	2	1	1
Don't Know/No Answer	9	10	9	7	5
Japan					
Very Friendly	11	2	1	4	5
Somewhat Friendly	57	52	42	62	68
Somewhat Unfriendly	25	40	48	26	20
Very Unfriendly	4	3	7	3	1
Don't Know/No Answer	3	3	2	5	6

Sources: New York Times/CBS News for U.S. data; Tokyo Broadcasting System for Japanese data. February 1989 poll.

One might speculate that because this poll already is a year old, it is outdated. Indeed, the New York Times and CBS recently released the results of a February 1990 poll that showed a much bleaker picture of the state of bilateral relations. When Americans were asked whether their feelings about Japan are "generally friendly" or "generally unfriendly," a full 25 percent of the respondents chose the negative characterization. Another recent poll indicated that over 40 percent of U.S. respondents selected Japan as this country's "least trustworthy ally." Similarly, when pollsters for Business Week asked Americans last year which country presents the most immediate threat to U.S. interests, Japan was the overwhelming "favorite."

If you had to say, which do you now think is a more serious threat to the future of the country -- the military threat from the Soviet Union or the economic threat from Japan?

The military threat from the Soviet Union	22%
The economic threat from Japan	68

Source: Business Week, August 7, 1989.

In the past year much has happened that could encourage such responses. The Bush administration's decision to make Japan a priority under the Super 301 provision of the 1988 trade act -- as well as to pursue the overarching Structural Impediments Initiative in order to tackle the underlying causes of the huge bilateral trade imbalance -- indicated Washington's frustration with the current state of U.S.-Japan economic relations. Tension also resulted from the debate surrounding U.S.-Japan negotiations on the joint development and production of Japan's next-generation fighter support aircraft (the FSX), with a storm of controversy resulting from the perception that the United States was giving away leading-edge aerospace technologies. Similarly, the flood of negative press reports regarding the purchases of Columbia Pictures and Rockefeller Center by Japanese investors did nothing to smooth over bilateral relations.

Being cited under the Super 301 provision was a thorn in the side of policymakers in Tokyo. Given the uncertain nature of Japanese political affairs in the immediate aftermath of the Recruit Co., Ltd. influence-peddling scandal, the Super 301 citation was perceived as coming at a particularly bad time. There was some feeling in Tokyo that Washington's decision showed insensitivity on the part of its ally to Japan's political situation. Consequently, Japan's official policy also has reflected a perception of increasing tensions. Nihon Keizai Shimbun reported in September 1989 that the most striking characteristic of the most recent Japan diplomatic blue book was its sense of crisis regarding U.S.-Japan relations. The blue book made reference to the deteriorating public opinion in the United States, noting that America's "view of a Japanese threat" was beginning to replace the "view of a Soviet threat." These comments were in marked contrast to the 1988 blue book, which noted the persistence of bilateral economic frictions but concluded that "this is a reflection of closer Japan-U.S. interdependent relations."

A slightly different -- although not necessarily more optimistic -- picture of the intensity of popular attitudes occurs when the question is rephrased. Specifically, the February 1989 New York Times/CBS survey discussed above demanded that respondents label relations in an "either/or" manner -- that is, as either mostly friendly or mostly unfriendly. When respondents have the option of choosing "neutral," even fewer respondents in both Japan and the United States choose "friendly." The "unfriendly" category also is less popular. A plurality of respondents in both countries opted for the "neutral" categorization in the November 1989 poll conducted by Yomiuri Shimbun and the Gallup organization:

Do you think that Japan-U.S. relations are better now, or do you not think so?

	1989	1988	1987	1986	1985	1984
United States						
Very Good	9.0%	7.7%	8.4%	14.4%	13.8%	14.8%
Good	36.6	40.4	39.9	45.3	46.4	44.0
Neither Good Nor Bad	40.4	39.1	38.7	32.0	30.1	31.7
Bad	9.3	6.0	7.0	3.4	4.0	3.2
No Answer	4.8	6.7	6.1	4.8	5.7	6.3
Japan						
Very Good	2.2	2.4	2.0	3.3	2.4	5.3
Good	35.8	39.3	30.6	38.8	38.4	47.7
Neither Good Nor Bad	36.1	35.4	34.1	32.1	35.0	31.5
Bad	18.4	17.5	26.7	16.8	16.9	8.1
No Answer	7.4	5.4	6.6	9.0	7.2	7.5

Sources: Yomiuri Shimbun for Japanese data; Gallup for U.S. data. November 1989 poll.

This poll indicates some ambivalence regarding bilateral relations. Only about half of the American respondents (and even fewer Japanese) were willing to assign a positive label to U.S.-Japan relations, opting instead for neutral or negative labels. The important question, of course, is why this should be the case. While these kinds of surveys give relatively little insight into the overall causes driving responses, one easy assessment might be that the level of economic tension between the countries places continuous strain on bilateral relations. While probably true, this may be an incomplete answer. After all, economic tension has been present in the relationship for most of the 1970s and

1980s. Indeed, trade tensions were running high in Washington in the 1984-86 period, during which time the opinion surveys above showed more positive feelings in both countries.

Another possibility is that the surveys reflect increasing uncertainty in both countries about the future of bilateral relations and, more broadly, the international economic system. Sentiment in the two nations appears headed toward a recognition that the bilateral relationship is undergoing a fundamental transition that will redefine the international roles of Japan as well as the United States. One indication of this is the plethora of recent written material that questions the stability of U.S. hegemonic dominance in the international system. Witness, for example, Paul Kennedy's The Rise and Fall of Great Powers and Akio Morita's and Shintaro Ishihara's The Japan That Can Say No.

The perception that the relationship is in a state of flux creates a large degree of uncertainty in both countries. Specifically, it raises questions regarding Japan's future role in such areas as bilateral trade, international economic policy leadership and overall influence in the United States. Too, the prospect of Japan's increasing economic strength raises some speculation about the future of bilateral security relations and the extent of burden-sharing Japan may be willing to finance. Moreover, perceptions of weaker military threats from Cold War foes and ongoing relative peace -- more striking in Europe than in Asia -- may restructure one country's view of security and not the other's. How strong will the U.S.-Japan security alliance remain? Is the world rapidly moving away from a largely bipolar world (with the United States and the Soviet Union as international superpowers) to a true multipolar world (with perhaps Japan and Europe gaining superpower status)? Whether or not there is a logical causal link, many Americans have suggested that as the Soviet Union becomes less of a threat, the United States should turn its attention to the real challenge to this country's international security: Japan's economic might. In these circumstances many Americans resent financing a U.S. defense budget amounting to approximately 6 percent of gross national product -- partly to protect Japan -- when this country's principal economic competitor spends only slightly more than 1 percent of its GNP for defense, mostly its own.

The current situation in Europe -- including both the liberalization of Eastern Europe and the impending 1992 economic unification of the European Community -- also serves to exacerbate the levels of uncertainty regarding the future of international relations in both economic and security arenas. With the media airing academic and policymakers' debates on these issues, it appears reasonable to assume that the public responds and that polls reflect the resulting sense of uncertainty. Similarly, this broad uncertainty appears to have translated to a sense of a Japanese threat among Americans and to a sense of impatience among Japanese vis-a-vis their U.S. counterparts.

Economic Relations: The Tension Continues

Regarding overall economic and trade issues, national opinion surveys reveal some surprises. Americans have been far more optimistic than their Japanese counterparts about the future of bilateral trade relations -- despite the prevalence of heated rhetoric in the United States concerning trade disputes. Nearly 70 percent of American respondents to a New York Times/CBS News poll predicted that the situation would improve or stay the same, whereas roughly 80 percent of Japanese respondents to a companion TBS poll foresaw no change or a worsening of relations:

> In the next few years, do you think the trade situation between the United States and Japan will get better, get worse, or stay about the same?

	1989	1988	1987	1986	1985
United States					
Get Better	31%	37%	38%	27%	35%
Get Worse	21	18	15	17	13
Stay the Same	37	39	38	47	47
Don't Know/No Answer	11	6	9	9	5
Japan					
Get Better	16	14	9	13	15
Get Worse	37	29	34	26	26
Stay the Same	43	52	50	56	54
Don't Know/No Answer	4	5	7	5	5

Sources: New York Times/CBS News for U.S. data; Tokyo Broadcasting System for Japanese data. February 1989 poll.

Moreover, for all the attention trade negotiators give to "protected" Japanese markets, U.S. respondents are more likely (at least in some polls) than their Japanese counterparts to endorse policies that reflect protectionism or economic nationalism:

> As measures for protecting [Japanese/American] industry, there are such ways as to impose a high tariff or a surcharge on imported goods, or restrict imports in quantity. Do you think that these measures are to be taken as a matter of course, or do you think that [Japan/America] ought not to do so? (Japanese were asked about Japan's trade policies; Americans were asked about U.S. trade policies.)

	Japan	United States
Measures ought to be taken as a matter of course	43.2%	66.1%
Ought not to do so	40.5	23.2
Other	2.5	1.1
No Answer	13.8	9.7

Sources: Yomiuri Shimbun for Japanese data; Gallup for U.S. data. November 1989 poll.

Similarly, Japanese "protectionism" in the agricultural arena is widely cited in this country as an unfair trade practice. Although U.S. pressure successfully brokered an agreement for Japanese liberalization of beef and orange imports, Tokyo's restrictions on rice imports continue to loom as a symbol of

Japanese intransigence on trade disputes. Yet sentiment here is even stronger than in Japan that agriculture is a sector that deserves protection:

> About "importing agricultural products," there are two opinions. A: 'It will be better to go on importing inexpensive agricultural products.' B: 'In order to protect the country's domestic agriculture, it is a matter of course to restrict imports.' Which opinion is closer to your view?

	1989	1988
Japan		
Closer to Opinion A	32.4%	39.2%
Closer to Opinion B	59.4	55.2
Other	2.0	1.0
No Answer	6.1	4.6
United States		
Closer to Opinion A	25.3	28.1
Closer to Opinion B	68.3	64.5
Other	2.2	0.6
No Answer	4.2	6.7

Sources: Yomiuri Shimbun for Japanese data; Gallup for U.S. data. November 1989 poll.

Finally, while respondents in both countries are rather predictably prone to wagging their fingers at the policies of the other country, polls reveal some recognition that blame could be shared. For example, a recent Business Week/Harris Poll in Japan found that 57 percent of the respondents believed that the United States was "trying to unfairly pressure" Japan. Nonetheless, 62 percent of these respondents also conceded that "Japan could be more flexible on trade." When asked about the specific areas in which Tokyo could be more flexible, most supported reform of Japan's distribution system:

> Now, do you favor or oppose the Japanese government taking any of these measures to improve trade relations with America?

	Favor	Oppose	Not Sure
Requiring that a certain amount of American products be allowed in Japan	45%	33%	22%
Reforming Japan's distribution system	64	12	24
Removing the ban on imported rice	39	48	13

Source: Business Week, December 18, 1989.

Although there is support for changing the distribution system, it appears that Japanese policymakers would have difficulty in mobilizing popular support for a reform of Japan's rice policies. The above poll actually may understate the amount of popular opposition to liberalizing rice imports. Another poll conducted by four Japanese organizations (including the General

Council of Trade Unions of Japan) found that a full 76 percent of the respondents agreed with the statement that Japan "ought not import rice." And regarding imported agricultural products, 95 percent of Japanese respondents agreed that "the government ought to carry out safety checks in the strictest way" -- a policy that U.S. critics often charge is used as a nontariff trade barrier but that probably is viewed by many Japanese as a public health measure.

If Japanese citizens recognize that their country bears some responsibility for bilateral economic tensions, U.S. respondents similarly are willing to acknowledge problems at home. Over half the Americans responding to a December 1988 Asahi Shimbun poll attributed U.S. trade woes with Japan to a lack of U.S. industrial competitiveness:

> Now, Japan-U.S. trade shows the Japanese side's large-scale excess of exports over imports. Do you think that the reason why there has been no increase in Japan's imports from the U.S. is that Japan makes it difficult for American products to have market access to Japan? Or, do you think it is because American products do not have competitiveness? (For U.S. respondents the first question was changed to "Do you think that it is because Japan shuts out American products from its markets?")

	Japan	United States
Japan makes it difficult to have market access/Japan shuts out American products	38%	38%
Not Competitive	36	53
No Answer/Other	26	9

Source: Asahi Shimbun. December 1988 poll.

Japanese Investment in the United States

If there is one area that has captured the attention of the American public more than any other in the past few years, it is the subject of Japanese direct investment in the United States. Perhaps because of its very visibility, foreign direct investment has sparked emotional, angry reactions in this country. Too, the control that Japanese investors have over U.S. fixed and financial assets via direct and portfolio investment has generated concerns that Japanese companies are gaining too much influence in this country. At the most general level the American public hears stories about Japan "buying America." At the more specific level there are concerns about the kind of influence that Japanese investors can wield over U.S. policymaking.

Prior to this year, however, the American public showed signs of ambivalence. For example, a July 1988 report by the Japan Society indicated that only 44.1 percent of respondents in California, Michigan and Tennessee (all of which host significant Japanese-affiliated manufacturing operations) agreed with the statement that "Japanese direct investment is good for the American economy." Yet a full 86.7 percent believed that "Japanese-affiliated companies have caused American manufacturers to become more competitive." The argument that Japanese investment creates jobs for American workers did not appear to carry great weight with the general public in these states; only 35.4 percent of the respondents agreed that "Japanese-affiliated companies provide employment opportunities in my community that would otherwise not exist." It should be noted, though, that the same statement produced very different reactions among U.S. employees of Japanese-affiliated companies, nearly 80 percent of whom believed that Japanese investment creates jobs that would not otherwise be available to American workers.

Extending the question to the national level, other polls have shown the nationalism attached to the investment issue. A 1988 survey by U.S. News & World Report asked the arguably leading question: "Foreign companies are building more and more plants in America, providing more jobs for Americans. Is that a good idea for the U.S.?" Despite the obviously favorable tone of the question, only 45 percent of the respondents agreed that manufacturing investments are "a good idea," while 49 percent disagreed with the statement. The same survey went on to ask a more neutral question: "Foreign companies are buying more companies and real estate in America. Is that a good idea for the U.S.?" An overwhelming 84 percent of the respondents said that such purchases were not a good idea. The survey went on to the issue of restricting foreign investment:

Should restrictions be placed on foreign companies buying these things in the U.S.?

	Yes
Companies making products related to national security	82%
Real estate	78
Manufacturing companies	72
High technology companies	72

Source: U.S. News & World Report poll by the Roper Organization, March 1988.

A 1990 poll commissioned by the Ministry of Foreign Affairs showed growing concern among Americans about Japanese investment. As reported in the February 24 Japan Economic Journal, a January survey by the Roper Organization found 44 percent of the respondents having "bad" feelings over Japanese investments in America. Those with "good" feelings came out to 27 percent. This contrasts with a similar Foreign Ministry-sponsored, early 1989 poll by Gallup in which 65 percent of those responding found Japanese investment here helpful and 24 percent had the opposite opinion. Among chief executive officers, however, a later 1989 survey commissioned by Nihon Keizai Shimbun and the Conference Board showed 69.7 percent of the respondents in agreement with the statement: "Japanese capital investments will strengthen the U.S. economy." The executives appeared evenly split, however, on the statements: "Acquisitions by Japanese companies will give them too much access to sensitive U.S. technology" (55.3 percent agreed) and "Growing investments by Japanese companies will give Japan too much economic power in the U.S. economy" (47.4 percent agreed).

Japanese critics have charged that part of the U.S. popular reaction to Japanese investment activities stems from racism. They point out that the same hostility has not been directed at British investment -- which tops the amount of investment from Japan. In fact, about 32 percent of the CEOs surveyed in the above-mentioned poll indicated they were uncomfortable about Japanese participation in the U.S. economy, whereas most had no qualms at all about European and Canadian investments. The Japanese press notes that there was little U.S. reaction when an Australian bought Twentieth Century Fox but that Sony Corp.'s purchase of Columbia Pictures prompted Newsweek to report that "[t]he soul of the United States was sold." Japanese critics also were unhappy with the way the American media characterized perhaps the most widely discussed Japanese investment of 1989, the purchase of Rockefeller Center. Some complained that U.S. headlines gave the mistaken impression that the New York City landmark was sold unwillingly to Mitsubishi Estate Co., Ltd.

Whether racism is a leading cause of U.S. emotionalism toward Japanese investment is an open question. Some have argued that Japan is singled out for special criticism because: Japanese investments tend to be more high profile than those of other countries; no other country is seen as being such a direct threat to U.S. international economic strength as Japan; and U.S. investors do not believe they have investment opportunities in Japan comparable to what they enjoy in Europe. Whatever the reason, there is no question that some Americans are suspicious of Japanese intentions. For example, a 1988 survey by Smick-Medley & Associates revealed that although Americans are willing to acknowledge Japanese business prowess, they are more reluctant to label them "trustworthy."

Which [nationalities]:	Japanese	British	West Germans	Arabs	Don't Know
Are most effective in business?	86%	2%	5%	1%	6%
Treat their workers best?	43	12	13	2	30
Make the best products?	60	4	27	1	8
Are the most trustworthy partners?	27	35	10	1	18
Should invest more in your state?	30	19	12	3	21

Source: Smick-Medley & Associates. 1988 poll.

Interestingly, Japanese citizens reveal some hesitation about the wisdom of Japanese investment in the United States. This may be because some Japanese businessmen have begun to acknowledge publicly that their own or their counterparts' U.S. investment activities could have been handled with more sensitivity. Indeed, some Japanese corporate spokespeople have admitted that they feel partly responsible for the negative attitudes that Japanese investment has generated in the United States. At any rate, over half of the Japanese respondents to a December 1988 survey by Asahi Shimbun expressed reservations about such investment:

> Recently, Japan has been investing profits, which were earned from its trade with the U.S., in plants, banks, real estate, etc. in the U.S. Do you think that it will be better to increase the amount of such investments further? Or, do you think that it will be better to hold down such investments? (American respondents were asked whether it would be better to "encourage," "hold down" or "neither encourage nor hold down" Japanese investment.)

Japan	
Better to Increase	19%
Better to Hold Down	55
Other/No Answer	26
United States	
Better to Encourage	10
Better to Hold Down	63
Neither Encourage nor Hold Down	23
Other/No Answer	4

Source: Asahi Shimbun. December 1988 poll.

In looking at why the investment issue generates such an intense reaction among Americans, one plausible explanation sees foreign investment in this country as a loss of domestic control and, more generally, a loss of U.S. international strength. The rationale behind this position is that purchasing goods and services from Japanese companies is quite different from letting this country's chief economic competitors acquire control over domestic financial assets and important portions of the manufacturing base. Combined with a general recognition that foreign investment can have beneficial side effects, these worries have sparked a political controversy that is likely to continue for the foreseeable future.

Japanese control of U.S. financial and physical resources has added to speculation about the changing relative power -- economic as well as political -- of Japan and the United States. Polls find that American respondents are concerned about the effects of Japanese investment on this country's national sovereignty, while Japanese respondents are much less likely to predict such grandiose effects of their business community's investment activities:

> Do you think that if Japan's economic advance into the U.S. becomes still stronger, Japan will have a big influence on the U.S. government's policy before long, or do you not think so? (American respondents were asked ". . . do you think that the U.S. government's policy will come under too big an influence from Japan?)

	Japan	United States
Will Have Big Influence/	36%	
May Come Under too Big an Influence		75%
Don't Think So	46	21
Other/No Answer	18	4

Source: Asahi Shimbun. December 1988 poll.

The Tension of an Evolving Relationship

Policymakers in both Japan and the United States recognize the need to reevaluate some aspects of their relationship. Tokyo has begun to search for ways to meet the international responsibilities that come with being an economic "superpower." Washington is facing the painful task of attempting to get its own economic house in order without abandoning its international commitments. As might be expected during a period of transition, some signs of tension are apparent as both sides reexamine not only their relationship with each other but their own places in the international system.

Perhaps the biggest source of tension in current bilateral relations is the uncertainty about the kinds of changes that are occurring. For example, some analysts argue that the United States is experiencing a period of hegemonic decline -- much as Great Britain did during the 1930s and the 1940s and after World War II. According to this line of argument, Japan is the emerging hegemon of the international system and therefore will replace the United States as an international superpower. Another view is that although Japan's financial prowess indeed is expanding, the eventual result will be a more equal relationship among the Western allies. This "interdependence" school envisions a world in which Washington no longer is the undisputed leader of the Western alliance but rather one among (more or less) equals. A third view sees America's current economic problems as not irreversible; consequently, with the adoption of appropriate policies Washington will be able to get its economic house in order and retain its international leadership position.

The public's doubts about these superpower debates were reflected in a February 1989 media-generated poll regarding the future of the U.S. international position:

Is the U.S. in decline as a world power?

	Japan	United States
Agree	49%	48%
Disagree	43	44

Sources: New York Times/CBS News for U.S. data; Tokyo Broadcasting System for Japanese data. February 1989 poll.

A sense of ambivalence also applies to the question of whether Japan will surpass the United States in political and economic leadership. Opinions range across the spectrum. Similar to the findings of the poll above, a U.S. News & World Report poll found that Americans are roughly divided on the question of whether other countries are threatening the U.S. position in the international economy.

Is the economic outlook for the U.S. over the next five years

	United States
Just so-so	59%
Gloomy	21
Bright	17

How well or badly is the U.S. competing with other industrialized nations?

We are slipping dangerously, but can still turn it around if we act decisively.	45%
We are still No. 1, but other nations are catching up with us very quickly.	27
We are in a period of long-term economic decline and will eventually lose our position as No. 1.	16
We are No. 1 and will remain the strongest, most dynamic economy in the world.	8

Source: U.S. News & World Report poll by the Roper Organization, March 1988.

When asked a similar question in late 1989 in a Business Week/Harris poll, few Japanese respondents appeared willing to make strong predictions, although a plurality agreed that Japan is a potential challenger to America's superpower status:

How much do you agree with the statement that eventually Japan will take America's place as the world's leading economic and political power?

	Japan
Agree Strongly	6%
Agree Somewhat	37
Disagree Somewhat	23
Disagree Strongly	12
Not Sure	22

Source: Business Week, December 18, 1989.

Not knowing the shape of the future international system does not prevent Japanese citizens from feeling frustrated with the status quo, however. Just as Americans display some hesitation regarding how much they are willing to trust their Japanese business associates, Japanese have mixed feelings about the United States. When asked very generally about their feelings regarding this country, over 60 percent of the Japanese respondents in the Business Week/Harris survey said they "have a sense of closeness or feel favorably disposed" to the United States. When asked more specific questions, though, these respondents appeared somewhat less favorably disposed to Americans:

How much admiration and fondness* do you have for each of the following?

	A Great Deal	A Fair Amount	Not Very Much	None at All	Not Sure
America as a nation	9%	33%	41%	13%	4%
America's economic success	6	29	40	16	9
The American people	7	25	45	18	5

*Translation disputed by some Japanese who say the Japanese word for adoration (akogare) was used rather than the word for fondness.

Source: Business Week, December 18, 1989.

Moreover, just as Americans are accused of racist motivations in their attitudes toward Japanese investment in this country, Japanese citizens have also been criticized for ethnic stereotyping. Thus, in selecting sources of U.S. economic problems, Japanese respondents often point to the racial diversity in this country:

> Now, please choose from this list which you think are the two or three reasons for America's economic problems.

	Japan
Poor education system	15%
Too many different minorities	42
Lazy work force	35
Incompetent management	11
Too interested in short-term returns	25
Insensitivity to foreign markets	29
None	7
Not sure	18

Source: Business Week, December 18, 1989.

If the above characterization of American people appears rather harsh, Japanese citizens do not spare their own society from criticism. In the most general terms Japanese respondents are positive about their country:

> Do you think that today's Japan is a good country in the world, or do you think that it is a bad country?

Very good country	30.3%
Can be said to be a rather good country	61.4
Can be said to be a rather bad country	5.4
Very bad country	0.5
No answer	2.3

Source: Yomiuri Shimbun, March 1989.

But the past few years have been hard on Japan's self-image, with the prolonged effects of the Recruit bribery scandal intensifying popular resentment about political corruption and growing inequalities in wealth and living standards among various groups in Japanese society. Thus, in a December 1988 survey the majority of Japanese respondents chose negative adjectives when asked to describe their own society.

> If you think that there is a word which suits the present way of society, pick only one.

	1981	1985	December 1988
Unfair	19%	20%	30%
Selfish	20	17	19

Stable	17	19	11
Disordered	10	10	11
Free	14	13	10
Corrupt	4	5	6
Prosperous	5	4	3
Solitary	3	3	3
Solidarity	2	1	1
Other/No Answer	6	8	6

Source: Asahi Shimbun, January 1, 1989.

Another effect of the political scandals has been a "turning in" of attention to domestic political events and away from international problems. At least among business and other economic leaders, there is little expectation that the current government will be able to pay much attention to the problems associated with Japan's expanding international role -- at least until domestic matters are resolved:

What do you expect of the Kaifu administration? (Plural answers are permissible.)*

Reforming politics	64.8%
Maintaining favorable business	17.9
Reviewing consumption tax	17.3
Stabilizing political situation	13.0
Dissolving external economic friction	12.3
Proper response to liberalization of agricultural products	6.2
Dialogues with opposition parties	4.9
Other	3.1

*Poll of managerial persons from businesses listed on first and second sections of the Tokyo Stock Exchange as well as leaders of national economic organizations.

Source: Tokyo Shimbun, September 7, 1989.

The Security Relationship

For all their economic disputes the United States and Japan often point proudly to their close bilateral security relationship. Yet the perceptions of the average American appear to differ significantly from those of the average Japanese. Again, the predominant feeling is one of uncertainty over the evolution of the relationship. One driving question posed by analysts in both countries is whether, given Japan's expanding financial resources, Tokyo will expand its military resources in the long run. More relevant in the short run is just how much Japan's economic might contributes to its current military capabilities. Despite calls in Congress for increased burdensharing, the American public is more likely than its Japanese counterpart to conclude that Tokyo's strength in the military sector already is considerable:

Do you think of Japan today as a very strong military power, a somewhat strong military power, a somewhat weak military power, or a very weak military power?

	1989	1988	1987	1985
United States				
Very Strong	7%	8%	7%	11%
Somewhat Strong	41	39	35	51
Somewhat Weak	27	28	30	21
Very Weak	11	14	9	9
Don't Know/No Answer	14	11	19	8
Japan				
Very Strong	10	5	5	4
Somewhat Strong	22	23	27	20
Somewhat Weak	36	42	44	45
Very Weak	26	25	19	26
Don't Know/No Answer	6	5	5	5

Sources: New York Times/CBS News for U.S. data; Tokyo Broadcasting System for Japanese data. February 1989 poll.

Too, there is some skepticism in Japan regarding U.S. dependability in the security arena. Perhaps given the economic tension between the two countries, Japanese respondents are not sure how credible is the U.S. commitment to Japan's defense. American respondents, by contrast, are overwhelmingly confident of this country's commitment to its allies:

If Japan were attacked, do you think the United States would defend Japan, or do you think the United States would not help Japan?

	1989	1988	1987	1985
United States				
U.S. would defend	77%	78%	78%	79%
U.S. would not help	8	10	8	8
Don't know/no answer	15	12	14	13
Japan				
U.S. would defend	44	45	39	42
U.S. would not help	46	50	57	54
Don't know/no answer	10	5	4	4

Sources: New York Times/CBS News for U.S. data; Tokyo Broadcasting System for Japanese data. February 1989 poll.

Added Uncertainty: The Future of Europe

Although the signs of change in the U.S.-Japan relationship might be ignored since it has evolved relatively gradually, the striking events in Eastern

Europe during the second half of 1989 are more than enough to force a reexamination of the future of the international system. As the political barriers in Eastern Europe come down, policymakers have begun to consider the possibility of a world in which East-West tension disappears or becomes so muted as to be almost negligible. The reunification of Germany, for example, might be the first step toward eliminating the difference between "Eastern" and "Western" Europe.

If these distinctions simply melt into one more or less unified "Europe," analysts are wondering, what would be the relevance of the North Atlantic Treaty Organization or the Warsaw Pact in Europe? One appropriate response might be for European countries to formulate a common defense policy -- a step that would almost certainly distance Europe from the United States. If the Soviet threat to East Asia were muted -- a process that has barely begun -- a key reason for a tight U.S.-Japan security relationship might be lessened. Thus, there has been speculation that the policies of Soviet President Mikhail Gorbachev might lead eventually to a loosening of the Western alliance and perhaps even the emergence of four international powers -- the United States, Europe, the Soviet Union and Japan. (Some analysts have suggested that five powers might emerge: the United States, the Soviet Union, Japan, Germany and the rest of Europe.) In other words, the unraveling of the Soviet bloc might lead eventually to the disintegration of the bipolar world and the emergence of a multipolar international system.

In the short run, however, the lessening U.S.-Soviet tensions might exacerbate problems in the U.S.-Japan relationship. That is, as the Soviet threat becomes more muted, U.S. attention is focused increasingly on changes in Europe. And while much attention has centered on the possibility of reducing U.S. military commitments to NATO allies, the lessening of East-West tension also is having an effect on American commitments in the Pacific (see JEI Report No. 9B, March 2, 1990). Tokyo's primary security concern remains the Soviet Union. But changes there as well as in Eastern Europe are prompting Tokyo to review its relationship with its neighbor to the East.

The American perception of a decreased Soviet threat has an even more direct implication for Japan in Washington. It has long been argued by officials in the Departments of Defense and State (among others) that the United States should not embrace harsh economic policies vis-a-vis Japan, a vital ally in the security arena. But if U.S. security concerns diminish, Japanese strategic support may become less vital to this country's short-term political and economic interests. This might lead U.S. policymakers to shift the nature of the linkages between military and economic issues, resulting in a greater willingness in Washington to give bilateral economic disputes more priority.

Another proffered scenario has less to do with the end of the Cold War but rather focuses on the consequences of the European Community's movement toward an integrated economic system in 1992. Specifically, successful EC economic integration may elicit reactions from Japan and the United States. Japanese policymakers especially have expressed concern at the mounting evidence that the world may be carved into regional trading blocs. The EC 1992 movement is at least partially an attempt by European countries to regain economic competitiveness vis-a-vis Japan; thus, Japanese businesses are afraid that they may be shut out of an integrated European market. Similarly, the conclusion of the U.S.-Canada Free Trade Agreement was aimed partially at bolstering U.S. international competitiveness relative to Japan's. In short, the events in Europe will have repercussions not only for the future of Eastern and Western Europe but perhaps for the entire international system. The role of Japan is likely to be affected significantly by EC integration as well as by the evolution of relations between Eastern and Western Europe.

Conclusion

The events of the past year have created a situation of flux that seems to defy reliable prediction. At the least, the international political and economic systems appear to be in a period of transition. The economic strength of Japan, the liberalization policies in Eastern Europe and the internal turmoil and more conciliatory posture of the Soviet Union in Europe all seem to point to the likelihood that the tight bipolar world of the postwar period will evolve to a much looser constellation of power. In this environment the U.S.-Japan relationship will continue to require redefinition, especially as Japan's expanding financial resources render it an even more significant player in the international arena. Adjustment is a painful process. The tension and the frustration associated with this process are reflected in national attitudes on both sides of the Pacific. Whether policymakers use the positive elements in these attitudes to support painful reforms or whether the public takes its cues from existing political and economic rhetoric will determine whether the U.S.-Japan relationship is adjusted in a manner that continues to provide stability in Asia and that contributes to world prosperity.

For further information, contact Eileen M. Doherty.

Currently a doctoral student in political science at the University of California, Berkeley, Ms. Doherty was JEI's government relations analyst from July 1986 through July 1988.

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The views expressed in this report are those of the author and do not necessarily represent those of the Japan Economic Institute.

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JAPAN'S ENVIRONMENTAL POLICIES: THE INTERNATIONAL DIMENSION

Summary

The world's attention to ecological factors has sharpened at the same time that Japan's economic stature has mushroomed. While many positive environmental models have developed within Japan (for energy efficiency and recycling, to name two), a less favorable image has clouded the initial picture of its international environmental policies. On the controversial issues of species protection and timber management Japan has been slower than some other industrialized nations to recognize that fulfillment of economic -- and sometimes political -- goals can pose long-term environmental pitfalls.

Yet Tokyo's hesitation to act has less to do with an insider's lack of concern for the outsider's problem and more to do with never before being faced with a leadership role in these areas. Japan's ability to change is evident in a variety of ways. And, evidence is growing that Japan is willing to play a role in helping developing nations achieve sustainable development and cope with global environmental problems, like destruction of the atmospheric ozone layer. Many also are looking to Tokyo to contribute to discussions between industrialized and developing nations on how to resolve worldwide environmental problems without undermining national sovereignty. Whether Tokyo will exercise a firm hand to prod Japanese corporations to accept global environmental responsibilities as well will be key to shaping the country's final ecological image as either a negative or a positive.

Japan Economic Institute 1000 Connecticut Avenue, N.W., Washington, D.C. 20036 202-296-5633

Overview

Called an "ecological outlaw" by Newsweek magazine and castigated in other international media reports for a variety of perceived environmental abuses, Japan suffers from an image problem. These abusive arrows target two main areas where Japan's external practices have caused alarm: species preservation and timber management. In the first instance international nongovernmental organizations have been extremely effective in raising awareness of the possible extinction of whales and elephants. Somewhat related is the concern raised by fishermen and their governments over the possibility that driftnet fishing, employed extensively by Japanese, Taiwanese and South Korean fishermen and on a smaller scale by some Americans, is wreaking havoc with fish stocks in the oceans. On these issues Japan's response has been mixed, appearing defensive at times and pragmatically flexible at others.

Timbering practices have flourished as an issue under the attention paid to global warming, the term given to the projected increases in temperatures caused by higher levels of such greenhouse-acting gases as carbon dioxide, methane and chlorofluorocarbons. The devastation of tropical rain forests is linked further to global warming since fewer trees are available to absorb CO_2 emissions; moreover, smoke from any forests burned to clear fields for agricultural uses also adds to CO_2 pollution. Japan's role in this controversy stems from its position as the world's largest importer of tropical hardwoods. In addition, Japanese companies in the past have aided less economically fortunate neighbors in Asia in developing their forest products industries, although environmentalists have questioned whether this help ultimately hurt. Prospects for aligning global environmental concerns with indigenous economic goals rely, in part, on Japanese willingness to broker compromises.

Although other industrialized nations pursued advantages in eras when there always seemed to be a new frontier, both the world and its resources seem to have shrunk. As world population has climbed, so have the number of toes that can be trampled in the name of commercial expansion. Nongovernmental organizations have sprouted to protect a myriad of causes, many of them controversial. Japan, which formerly pursued its search for resources with little attention to ecological factors, now is called on not only to weigh the possibility of environmental degradation from its own actions but to caution other countries to consider the environmental impact of what they do.

Some who hear Japan being urged to serve as the middleman for boosting the Third World's attention to environmental measures may conjure the image of a fox guarding the henhouse. In financial terms Tokyo certainly is ready to commit resources. Political leadership, too, is increasing, as seen in the government's role in the Intergovernmental Panel on Climate Change, organized by the United Nations, and its joint sponsorship with the U.N. Environment Program of a 1989 environmental conference. On several fronts, though, the financial and political leadership exercised by Japan has been at odds with some of the goals of international environmental groups. As the country develops its global leadership abilities, its renowned spirit of consensus and government-business coordination may work out compromises acceptable to all parties.

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Mixed Signals on Species Preservation

Japan has approached its harvesting of the oceans and, to a degree, trade in endangered species from a pioneer-society mentality, rendered more acute by its own limited supply of natural resources. Given this view, the country is no different from many other pioneers who sometimes recklessly have hunted, mined or fished. While those familiar with Japanese culture may claim that Japan's environmental actions are based on its uchi/soto (inside/outside) response to situations, this reasoning fails to recognize that many strong nations have acted similarly as they have imposed their will on areas that appear, or are, lightly regulated. A pioneer society and the uchi/soto mentality are similar in that both fail to treat external resources as finite. Yet the pioneering society usually progresses to a higher level of cooperative maturity. In some areas Japan is beginning to show signs of that maturity. Nevertheless, cultural explanations frequently surface for some disputed practices, such as whaling.

Whales - Cursory reading of the popular press in Japan shows that support for whaling stems from wanting to retain the heritage of some seaside villages and the role of whale meat as a source of food. The more academic press questions whether the moratorium placed on commercial whaling in 1982 by the International Whaling Commission (which took effect in 1986) is based on sufficient scientific information. Also hinted at by a few Japanese is a suspicion that the moratorium reflects other nations' unspecified political goals rather than concern for depleted whale stocks.

Japan acquiesced to the IWC's commercial whaling moratorium in the 1987/88 season. But under a provision of the IWC convention regulating whaling, Tokyo is carrying out research on minke whales. The result is not only a count of these whales but selective killing of about 300 a year to determine age and sex, from which scientists hope to calculate population patterns. Japan's ultimate goal is to prove that the minke whale is not endangered and, in fact, that its population is increasing. A review of the moratorium is set for this year, although researchers do not expect to have sufficient data ready by then.

The year the commercial moratorium took effect, Japanese fleets reportedly harpooned 1,941 minke whales. In the 1987/88 season, the first year of its research, the Tokyo program initially called for taking 825 minke whales; a resulting outcry prompted the kill to be limited to 273, as reported by the Institute of Cetacean Research set up by the Ministry of Agriculture, Forestry and Fisheries. The following season 241 minke whales were examined. At the June 1989 IWC meeting Tokyo reported plans to kill and dissect about 400 minke whales this next season. The government provided Y350 million ($2.5 million at Y140=$1.00) toward the 1987/88 research, which cost an estimated Y1.7 billion ($12.1 million). The sale of whale meat offset about Y1.3 billion ($9.3 million) of project costs, while private contributions from whaling companies covered the remainder. The 1988/89 season's research cost an estimated Y2 billion ($14.3 million).[1]

[1] Fukuzo Nagasaki, "A Disguised Commercial Operation? The Costs of Scientific Whaling," Science & Technology in Japan, July 1989, p. 37.

The main contention underlying Japanese support for whaling is that not all species are in danger of extinction. The executive director of the Institute of Cetacean Research has written that if the IWC partially lifts its commercial whaling moratorium ". . . Japan will only harvest the relatively plentiful minke whale. We believe that stocks of other species, in particular the Bryde's whale, may be sufficient to support future exploitation, but population analyses are presently insufficient. In fact we have no clear idea of stock size for any species other than minke."[2] However, Japan has been accused of taking more than minke whales in its research. And some question whether the country's whaling fleets would go after some of the other five species that Japan listed as an exception to its recognition of their endangered status under the Convention on International Trade in Endangered Species of Wild Fauna and Flora, known as the Washington Treaty.[3]

Since only Norway and Japan retain research projects for whaling (Iceland agreed last August to give up its program), the pressure on both to put away their harpoons has intensified. Norway killed 29 whales in 1988 and projected taking 20 in 1989, according to a report out of the IWC's June meeting. Comments at that session were mixed; the more liberal general session criticized all the researchers and called on them to end their programs, while some members of the science committee, which met before the general session, were said to have praised Japan's survey, particularly the population count, which did not involve killing whales. Adding to the uncertainty over the future of whaling is Japan's acknowledgment that while the minke population appears to be increasing (estimated at 700,000 in 1988-89 surveys), the higher figures could result from the researchers' use of better methods than those formerly supplied by commercial operations.

The push will be on before the July 2-6 IWC meeting in the Netherlands as Tokyo assesses the international political opposition to whaling in light of the value of sustaining one of its traditional industries. Apparently not ready to lend much credence to one proposal for "whale farms" as a way to preserve the species, Tokyo will have to decide whether its minke research is accurate and deserving of continued support or whether political concessions as they relate to the broader fishing industry carry more long-term gains. Since few in Japan have rallied to "save the whale," preservation itself is likely to be a small factor in Tokyo's final response. Further threats from Washington and other capitals to withhold fishing rights, a tactic reportedly used to help gain compliance with the IWC commercial moratorium, push the decision into the realm of political compromise.

Driftnet fishing - The use of miles-long nets to increase a fishing fleet's catch exemplifies a pioneer-society mentality. These new tools exploit

[2] Fukuzo Nagasaki, "The Facts, 'Facts' and Fiction of Scientific Whaling," Science & Technology in Japan, July 1989, p. 37.

[3] Japan has filed exemptions under the CITES treaty on six whales: sperm, sei, Bryde's, fin, Baird's minke and minke. All are listed as endangered. Researchers reporting on selected whale populations at the June 1989 IWC meeting estimated that no more than 20,000 sperm whales survived as against earlier reports of 1 million, while the number of fin whales had dropped to 5,000 from a 1976 count of 100,000.

what seems to be a plentiful resource in the oceans. But opponents say they snare whales, dolphins and other off-limits species as well as sea birds feeding in the ocean. This leads, critics say, to the equivalent of ocean strip-mining. Proponents of the nets say they are designed to allow certain species to escape, and the Japanese maintain unintended catches are few. Until there is scientific proof that driftnet fishing threatens to deplete fish stocks, Japan has indicated its belief that the method causes no more harm than other methods and supports research to clarify the issue.

Another issue involving driftnets is that certain species of fish are off-limits in that they are considered the "property" of the nation in whose waters they spawned. Unintended catches are supposed to be tossed back. Since driftnets are not emptied frequently, stray fish or mammals caught in the nets are not guaranteed survival. West Coast American fishermen have appealed to their congressmen, however, claiming that foreign driftnets caught enough off-limits salmon to seriously restrict domestic catches in 1988 and 1989. They claim that interception by driftnets cut their catch of tuna and salmon from an estimated 17,000 tons a year in the early 1980s to about 4,000 tons in the late 1980s and possibly only 2,500 tons in 1989. To ward off accusations of pirating these forbidden catches, Japan has agreed (as have South Korea and Taiwan) to monitoring in the North Pacific. However, legislation originating from these complaints is pending to ban imports of fish caught in driftnets.

In addition to agreeing to the monitoring, Tokyo has shown its willingness to bend by cutting back the number of boats (from 60 to 20) using driftnets in the South Pacific (see JEI Reports No. 8B, February 23, 1990, and No. 20B, May 19, 1989). Moreover, in a compromise with the United States at a December 1989 United Nations meeting, Japan agreed that if no method can be found to avoid catching sea mammals in driftnets, then it would forgo their use. The deadline to avoid such a ban is June 1992. A July 1991 deadline would limit use of driftnets in the South Pacific. Tokyo also has suggested creation of an international commission to regulate regional fishing. The driftnet controversy is part of a larger problem facing fishing nations, which are being forced into open waters as more domestic fleets succeed in pressuring their governments to restrict access in their 200-mile economic zones (see JEI Report No. 16B, April 16, 1989).

As with many issues, driftnet fishing concerns more than just resource preservation. However, nations accused of exploiting a resource face not only the frustration of commercial interests, with which they are used to dealing, but the wrath of environmentalists as well. Japan, where international environmental lobbies are rare, faces a relatively unknown antagonist. But Tokyo has shown it can be swayed by international environmental opinion, particularly in its approach to some of the endangered species listed under CITES.

Elephants and other endangered species - In the eyes of those concerned about extinction of various animals, Japan may have redeemed its past trade in endangered species -- at least partially -- with a decision last year to comply with a ban on ivory imports. When the proposal to ban trade in ivory was debated at an October 1989 CITES conference, many expected Japan, which had been consuming an estimated 40 percent of the world's ivory exports, to oppose listing the African elephant as an endangered species under the most restrictive appendix. Despite the efforts of some African nations to carefully manage their herds, Africa's elephant population had declined from an estimated 1.3 million to roughly half that in just 10 years. Japan could have sided with these nations. And, in fact, Tokyo's delegate did not vote in the first balloting when 76 of the 91 nations represented there voted for the ban. Furthermore, Tokyo briefly considered whether to file an exemption to the appendix, which would have allowed trade in legally obtained elephant tusks with other countries that had filed exemptions. In the end, though, members of the Japanese cabinet decided to avoid the international opprobrium that might accompany continued ivory trading.

When the ban took effect this past January, Japan simply continued what had been a temporary ban enacted in September. Some conservationists criticized Tokyo's gradual tightening of restrictions. They noted that a June 1989 decision to allow imports of raw ivory only from the country of origin had resulted in traders buying almost a half year's supply of ivory in a two-month span. The influx of 60 tons brought supplies to about 110 tons by the time the temporary September ban took effect, meaning the 30,000 ivory craft workers in Japan had slightly less than their previous year's supply of roughly 140 tons.

With both Hong Kong and China deciding in January to ignore the CITES trading ban, some worry that Japanese ivory traders could have illicit access to further supplies. (Airport confiscations in November and December netted various amounts of ivory being smuggled into the country.) Moreover, since the CITES restrictions will be reviewed in two years, analysts have suggested that Japanese ivory workers might be able to survive until then on stockpiles. Japanese sources say, however, that international concern over the elephant probably will outweigh demands of the Y20 billion ($142.9 million) a year domestic industry, which either will have learned to deal with substitutes or have moved into other fields.

After the Diet passed a law in 1987 to regulate traffic in endangered species, customs officials were able to increase surveillance; in 1989 they confiscated 9,799 items listed under CITES. What worries conservationists, however, are the endangered species for which Tokyo has requested an exemption from trade restraints under CITES. These include the hawksbill turtle, olive ridley turtle, the Bengal monitor (lizard) and the yellow monitor. Craftsmen use the turtle shells and the lizard skins primarily for fashion accessories.

Prohibited trade in live animals, too, has flourished in Japan. A noted recent case involved 58 wild animals, including three rare slow lorises, which Japan returned to Thailand. News reports called the event the largest return at one time of rare species to their native lands. Some of the animals had been confiscated in 1986 and kept in state custody since then. Wildlife conservationists are urging governments not only to confiscate the animals but to bear the costs of returning them. For its part, the Ministry of International Trade and Industry has responded to the indignation of wildlife advocates by attempting to beef up customs inspections. Adding to the difficulty of spotting illegal documents is the increasing professionalism of importers. One MITI official was quoted as saying, "Like drug trafficking, the trading of rare animals is becoming a new source of funds for criminal organizations."[4]

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[4] Yuko Inoue, "Japan a Thriving Market for Endangered Species," Japan Economic Journal, July 15, 1989, p. 28.

Tokyo hopes to show an improved record against such smuggling before the next CITES meeting in the spring of 1992. That meeting, to be held in Japan, may reflect Tokyo's willingness to participate more actively in global conservation matters. Coinciding with its bid for the conference, Japan agreed to abide by the CITES prohibition against trade in saltwater crocodiles. Tokyo's decision to go along with the ivory ban also was considered key to winning the conference, the first in Asia since 1981.

The Impact of Hardwood Hard Knocks

A country renowned for its long-term views in business management might be expected to encourage reforestation by its suppliers of wood and pulp. This might seem even more logical if that country happened to be the world's largest importer of tropical hardwoods. As Japan's wood traders have hopscotched in search of supplies -- relying heavily on the Philippines, then Indonesia, then Malaysia and now Papua New Guinea -- the main sources of tropical hardwoods have shrunk; easily accessible timber has been depleted or governments have revised their export policies. Japanese importers continue to look for additional supply sources, including Brazil, but new attention to the impact of deforestation on global warming has added to the scrutiny of Japanese forest products importers and their past practices. So-called tree huggers who have criticized Japan and called for boycotts of tropical timber are finding that they are shaking out a hornet's nest of commercial and sovereign issues.

Getting the picture - Some criticisms of rain forest depletion are based on unclear data. Clearer, however, is Japan's trend toward new sources of supply and a regional history short on ecological practices.

- A statistical problem - Getting to the root of deforestation is problematic. Rough estimates say about 27.9 million acres of the earth's 2.9 billion acres of tropical forest are destroyed annually. The lack of a clear picture of how much is destroyed, how much goes for unreported local uses and how much goes into commercial sales contributes to heated discussions that tend to overlook a basic point. A sustained management plan for a forest would help offset the destruction and protect indigenous populations, government sovereignty and users of the forest's resources.

Stung by criticism connecting Japan's wood demand with the depletion of Southeast Asian forests, the Foreign Ministry pointed out last year that Japan takes only a small proportion of the total wood cut, about 2 percent or 458.8 million cubic feet out of the 22.9 billion cubic feet produced. Only about 4.5 percent of the total Southeast Asian cut is exported, the ministry reported, with the rest either processed for local use or used for fuel. Some forests are destroyed through slash-and-burn field-clearing for agriculture, although fewer Southeast Asian forests are affected by this method than, for example, those in Brazil.

Further complicating the tally of shipments, according to a study by the World Wide Fund for Nature -- the world's largest conservation group and parent of the World Wildlife Fund, is a discrepancy between amounts shipped and amounts received. The authors of a 1989 report suggested that Japanese companies have helped local Papua New Guinea loggers avoid government taxes or royalties through "transfer pricing" programs that pay a middleman for actual shipments, which are recorded out of port at lower quantities.[5] To help clarify at least the extent of deforestation, the Agriculture Ministry has asked that its FY 1990 budget be funded for a Y300 million ($2.1 million) five-year study that would use a satellite to map changes in Southeast Asian forestry resources.

- A search for supplies - With the world's largest share of tropical hardwood imports (about 30 percent), Japan has an important stake in obtaining continued supplies for its construction, paper and pulp and furniture-making industries. Currently, Japan imports about 727 million cubic feet of tropical hardwoods a year, primarily from the Malaysian states of Sarawak and Sabah (but not Peninsular Malaysia, which has restricted exports of logs) and Papua New Guinea (the only Southeast Asian timbering state without government-set limits on logging). In the past Japanese traders tapped Indonesia and the Philippines, but both countries have imposed bans on log exports, although shipments reportedly are continuing illegally. (The bans are not necessarily due to concern for sustaining forests but to decisions to export value-added wood products.)

- Ecology not a past priority - Criticism over the trade in timber has focused primarily on accusations that the supplying country has not managed its forests well. Japanese foreign aid practices also have been targeted for not requiring adequate environmental impact assessments, resulting in some cases of commercial gain at the expense of the environment. Both issues involve a scarcity of trained personnel, either in the country trying to oversee its logging operations or in Japan's offices that handle foreign aid projects.

The WWF report, Timber from the South Seas: An Analysis of Japan's Tropical Timber Trade and its Environmental Impact, pointed to three props that have kept timber production high: "Once logging has started, the loggers (who have borrowed heavily), trading houses (who have engaged funds) and the authorities (who are starting to receive taxes and royalties) cannot curtail their operations because they have so much at stake."[6] Japan enters into that equation through its trading houses and other companies that either are in partnership with logging operators, are their capital suppliers or contract with them for timber yields. However, even if Japanese firms pushed for a greater environmental component in timbering operations, the loggers and the local authorities remain in charge of the final outcome.

Focusing on ways to change - Sustainable management principles and changes in consumption patterns that rely less on hardwoods have been suggested as two ways to prevent decimation of tropical rain forests. While exporting governments agree with the need for good husbandry, they resent the implication from critics that they do not already require good forestry techniques. The International Tropical Timber Organization -- a United Nations affiliate based in Yokohama -- has cited specific operations in Malaysia, the Philippines and Indonesia as having good track records. However, ITTO also noted in a 1988 report that proper management methods are used in less than 1 percent of all tropical forests.

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[5] Francois Nectoux and Yoichi Kuroda, Timber from the South Seas: An Analysis of Japan's Tropical Timber Trade and its Environmental Impact (Gland, Switzerland: WWF International, April 1989), pp. 73-74.

[6] Ibid., p. 71.

A WWF recommendation to alter consumption patterns encompasses a suggested boycott of tropical timber logged by operations that engage in questionable management practices. (The actual proposal is to mark the hardwood product so that consumers can respond by buying timber from properly managed forests.) Another consumption-related suggestion calls on Japan to use more softwood for plywood and especially for construction frames (konpane), which are used and then tossed.

Exporting governments angrily condemned the WWF boycott proposal, which some European countries are considering. Indonesia's forestry minister visited five nations late last year to ward off a boycott and urge increased help in forest preservation. Hasjrul Harahap, who doubled as a representative of the Association of Southeast Asian Nations on his tour, suggested sinister reasons were behind the proposed boycott. Beyond taking a position that nations have a right to develop their resources as they see fit, Mr. Harahap warned that the motive for the boycott may lie in the desire of softwood exporters to get consumers to replace hardwood purchases with softwood. This charge appeared indirectly aimed at the United States -- Japan's biggest forest products supplier -- since Washington is pushing under the Super 301 provision of the 1988 Omnibus Trade and Competitiveness Act for revisions in Japan's tariffs on plywood and other panel products, classification codes and building standards to clear the way for increased imports of U.S. wood products (primarily softwood).

Chipping in with funds and guidelines - Japan's response to the depletion of rain forests has been primarily to dig into its wallet. Under its flagship environmental financing package announced in July 1989 at the annual summit of industrialized nations, Y300 billion ($2.1 billion) in foreign aid will be targeted for environmental measures over the FY 1989-FY 1991 period; some of it will go specifically for reforestation projects. Japanese aid already has provided either grants or technical assistance to 17 projects involving surveys, reforestation programs or training centers in various African, Southeast Asian and South American countries. Six of these have been completed and 11 are ongoing.

The Foreign Ministry incorporated in its FY 1990 aid request approximately Y1.3 billion ($9.5 million) to fund an ITTO program for preserving forests and about Y300 million ($2.1 million) to finance a program supplying technical experts to developing countries. Furthermore, ITTO is expected to receive a supplemental FY 1989 appropriation of Y2.7 billion ($19.3 million) for help in launching a world forest fund. Also, a coalition that includes the Foreign Ministry and the Environment Agency formed the Japan International Association for Mangroves in September 1989 to research and provide information geared to protecting the swampland tree systems unique to Southeast Asia. An unspecified amount of financial aid is to be provided to the institute. Japan also contributes indirectly through other multilateral groups like the Tropical Forestry Action Plan of the U.N.'s Food and Agriculture Organization and the U.N.'s Environment Program, to which it is the second-largest contributor after the United States.

Even forest products trading firms are contributing financially, although they reportedly have said they will not alter their practices. Through the Japan Lumber Importers Association traders have contributed Y10 million ($71,400) to ITTO to help protect rain forests.

Perhaps partly in response to criticisms of its foreign aid programs, Japan has renewed its attention to environmental assessments, beginning with the initial request for aid. In late 1989 the Overseas Economic Cooperation Fund, which administers all of Japan's foreign aid loans, issued a set of guidelines aimed at weighing environmental factors along with development proposals. Prominent in the guidelines is the need for participation by the country requesting aid. However, to deflect criticisms that Japan might slough off addressing ecological impacts whenever a potential recipient had no environmental regulations or administrative guidelines, OECF promised that Japanese standards or those of other countries or international organizations would be used in consultation with the requesting government.

The standards for forestry-related projects, in particular, require an assessment of the project's impact on the surrounding ecosystem, including the watershed, as well as the potential contribution to global warming (as it relates to carbon dioxide, for example). Further studies are urged for the impacts on plants, animals and insects. Additionally, OECF is pushing for consideration of human environmental issues: the effects on farmers, the impacts on cultural or religious heritage and the project's relation to land ownership or community rights.

The tropical timber issue provides a classic example of how Japan can switch from a pioneer approach to one more in line with its ability to use its own financial resources for improving the commonweal. Emanating from its strength as the world's largest source of funds, Japan is exercising more political leadership as well.

Taking a High-Profile Role on Global Environmental Issues

Japan was by no means a laggard as industrialized nations began to raise environmental banners late in the 1980s. Its 1988 white paper, Japan's Contribution Toward the Conservation of the Global Environment, offered an outline for future actions. Moreover, Japan joined with the other Group of Seven industrial democracies in their July 1989 call for increased attention to environmental matters. In addition, it has participated in the work of the Intergovernmental Panel on Climate Change to promote ways to address carbon dioxide. Its plan to eliminate chlorofluorocarbons accused of depleting the ozone layer could be cited as a model for other nations. And not to be outdone by other countries staging environmental gatherings, Japan joined with the U.N. Environment Program to sponsor a sustainable development conference last September.

Outline for action - The Environment Agency's 1988 white paper emphasized two of Japan's strengths in dealing with global environmental measures: financial aid and technological prowess. The paper also promoted cooperation with nongovernmental organizations and supported the transfer of appropriate energy-efficient technologies by multinational companies to their Third World subsidiaries.

With Japan increasing its overall foreign aid disbursements -- penciling in $50 billion for the 1986-90 period (see JEI Report No. 41A, October 27, 1989), environmentalists worry that pollution-creating or resource-depleting projects will dominate despite pleas for environmental attention. Not even the Y300 billion ($2.1 billion) announced specifically for environmental projects over the FY 1989-FY 1991 period will prove effective if skilled environmental technicians are not available to evaluate programs. A call from the Environment

Agency for experts last May netted only 200 names. Given the increased emphasis on environmental monitoring, the bureaucracy may be able to enhance its own downstream training potential by encouraging multinational corporations to beef up their ecologically attuned staff.

Underlying the white paper's sense of what Japan could do through financial and technical aid was a recognition that developing countries seldom make environmental concerns a high priority in relation to industrial development. Tokyo's past aid policy of emphasizing project origination from the requesting country easily could ignore the environmental element, the paper suggested. Thus, ". . . the Japanese government should make flexible use of this principle, enlightening these countries about the importance of environmental problems, and actively working on these countries to assist them to draft projects for conservation of the environment" in ways that meet the needs of the countries.[7] A similar attention to sustainable development resurfaced in both the G-7 communique from Paris and as the theme of the Tokyo conference in September.

Front-line positions - Last year's summit meeting of the heads of the seven leading industrial democracies provided the setting for Japan to officially announce its Y300 billion ($2.1 billion) three-year commitment to environmental projects (of which the Foreign Ministry said in September more than one-third already had been disbursed). The third of the communique that described the group's environmental concerns basically reiterated previous positions: support for preservation of forests and assisting developing nations to achieve sustainable development plus concern over global warming and ocean pollution, among others. The August 1989 response from a Foreign Ministry task force, established to follow up on the summit report and to prepare for a September environmental conference in Tokyo, was somewhat more to the point. It urged a phaseout of CFCs as soon as possible before the year 2000 and further study of the greenhouse effect, including analysis of worldwide carbon dioxide levels as well as implementation as soon as possible of energy conservation and efficiency measures that reduce CO_2 emissions. The other task force recommendations reinforced aid philosophies.

Tokyo already is moving toward a CFC phaseout. Most scientists suspect that the chemicals, used to produce foam, aerosols and refrigerants as well as to clean electronic equipment, are destroying the earth's ozone layer that protects against too much ultraviolet light striking the planet. As a signatory to the 1987 Montreal Protocol, Tokyo accepted initial CFC cutback proposals and has agreed to proposals made in Helsinki last year to work toward elimination of CFC use by the year 2000. Specifically, the Ministry of International Trade and Industry has drafted a strict schedule that calls for cuts within three years to 80 percent of the production and use figures of 1986, further tightening the limits to 50 percent by the 1995-96 period, 15 percent by 1998 and a total phaseout by the year 2000. The timetable is to be presented at a March 8-14 meeting in Geneva. Several Japanese (as well as American) firms have developed chemicals that can substitute for CFCs, thus decreasing the economic impact of the phaseout.

[7] Environment Agency, Japan's Contribution Toward the Conservation of the Global Environment, May 1988, p. 73.

Japan has taken an active role in global warming issues through the Intergovernmental Panel on Climate Control, where it coordinates the energy and industry subcommittee for solutions on carbon dioxide emissions. Neither Tokyo nor Washington was willing to set a timetable for CO_2 cutbacks as pushed by several European nations at a November conference in the Netherlands (see JEI Report No. 44B, November 17, 1989). Instead, they promoted waiting to see what measures IPCC would suggest in its October 1990 report. Various proposals submitted to IPCC reportedly have shown few countries actively seeking to decrease their CO_2 emissions, sources say. Japan's proposal emphasizes energy efficiencies and technological innovation to limit increases in CO_2 emissions.

A Y1.2 billion ($8.6 million), six-year study coordinated by the Environment Agency on the effects of global warming, ozone depletion, ocean pollution, desertification and acid rain will not be complete by the time IPCC makes its recommendations. However, the information is to be used in making plans for changing climatic conditions as well as other policies.

Japan also has been active in studying how to minimize methane emissions (formed in rice fields, given off by the decay of garbage, produced by combustion plants and a simple result of livestock flatulence). A 1989 Environment Agency report presented to IPCC noted that Japan produced about 1.1 million tons of methane a year. U.S. studies have suggested that methane actually could contribute more to global warming than CO_2 because its rate of increase is higher. A February IPCC meeting included methane reduction discussions, which will be explored in more detail at an April 9-13 meeting in Washington.

At the September 1989 Tokyo Conference on the Global Environment and Human Response toward Sustainable Development four familiar recommendations emerged: increase information to decrease the uncertainties about global environmental issues; develop and share technology to cope with issues of degradation; provide funding for sustainable development; and strengthen the abilities of international and regional organizations to respond to problems. Although the conference did not reverse the usual rhetoric, the scientific and official representatives addressed the importance to the environment of alleviating poverty and inequity in Third World nations (see JEI Report No. 36B, September 22, 1989). The conference also generated controversy through a decision to limit attendance primarily to scientists and government officials. Thus, representatives of many nongovernment organizations staged their own conference that ended up raising questions about some of Japan's environmentally questionable actions in Southeast Asia but also underscoring the need for a cooperative approach to sustainable development.

Money Doesn't Necessarily Buy Love

From all parts of the globe the cry is heard in Japan: money, money, money. Missions visit Mexico and Poland to study air pollution. Officials contact Asean nations to coordinate environmental aid and sit down in Eastern European capitals and Moscow to discuss a variety of environmental concerns. While Japan has expressed its willingness to provide aid, a variety of cautions slow the process, including a variation on the theme "money can't buy love," since not all aid projects win kudos.

Among the proposals for tapping Japan's economic might on behalf of the environment is a debt-for-nature swap, in which a creditor buys usually discounted debt and, ideally, converts it into the currency of the debtor nation for an amount somewhere between face value and the discounted price. The converted funds then sponsor a conservation project, often determined by a conservation group within the debtor nation.* The communique from last summer's summit meeting noted, "In special cases; [official development assistance] debt forgiveness and debt-for-nature swaps can play a useful role in environmental protection." However, sovereignty issues occasionally flare over the concept; for example, Brazil's then president angrily denounced as an affront to Brazil's sovereignty proposals by environmentalists last year to buy some of the country's massive debt in exchange for rain forest preservation. Japan's traditionally cautious approach to debt reduction (see JEI Report No. 6B, February 9, 1990) indicates this measure will not soon gain popularity in Tokyo.

One attempt at linking its aid to environmental issues actually worked in the reverse as Tokyo allegedly reminded 13 South Pacific nations of the amount of Japanese aid they were receiving. Representatives had met in July 1989 in Tarawa, Kiribati to seek a ban on driftnets in the South Pacific. Australia and New Zealand, which are also members of the South Pacific Forum, leveled accusations at Tokyo of "checkbook diplomacy," which may cool similar attempts in the future.

Despite allocations of $193 million for bilateral and multilateral environmental preservation efforts in 1986, $335 million in 1987 and $797 million in 1988, Japan's seemingly thick wallet is not always appreciated. In one much reported case Japanese foreign aid contributions were linked to construction of a road in Sarawak. When Penan natives of the area blockaded the road to keep loggers from entering the area, Malaysian authorities arrested slightly more than 100 men, women and children, according to news reports. The Penans say logging in their ancestral lands has eroded soil, polluted waterways and disturbed fisheries. That the road had been built ostensibly to help Penan proved fodder for those who question how well Japanese foreign aid officials evaluate projects. In another case Japanese participation in a reforestation project in Thailand has drawn complaints from farmers there who dislike the idea of fast-growing eucalyptus being used since the trees' root systems interfere with nearby crops. And Japanese companies that are urged to share technology may find that their wealth only buys them a bad image if that technology ends up causing pollution.

Technology, however, also may be the key to counteracting environmental degradation. Tokyo hopes to pressure industries to transfer antipollution technologies abroad as well as possibly clean up their act overseas, if necessary. Fiscal policies, such as a surcharge on hardwood timber imports, also have been suggested as a way in which Tokyo can work to sway the environmental policies of industry. Tax incentives have been proposed by Keidanren (Japan Federation

*Last year the World Wildlife Fund and the Nature Conservancy bought from U.S. creditors $9 million worth of Ecuador's debt at a discount of 11.875 cents to the dollar. For the groups' payment of $1.07 million Ecuador got a one-to-one conversion of the commercial bank debt into bonds denominated in its own currency, which were used to underwrite conservation of the country's rain forests. So far, most of these swaps have been engineered by conservation groups, although the U.S. Agency for International Development joined WWF last year for a project in Madagascar.

of Economic Organizations), which has set up a "global greenery" fund of Y2 billion ($14.3 million) to be used for such projects as irrigation or irradicating deserts. Corporations given tax relief for similar contributions, the business group has suggested, may prove more active in international environmental matters.

Conclusion

If Japan seriously considers some of its policies to be detrimental to the global environment, chances are high that Tokyo will work with industry to engineer a policy revision. Proposals on how to combat global warming and the harm caused to the ozone layer by chlorofluorocarbons show Japan's confidence in its ability to use technology to cure a multitude of environmental problems. On some fronts, such as whaling and driftnet fishing, policymakers remain unconvinced that a problem exists. In these cases the government has stuck to a call for more scientific information before forming a judgment. On other fronts the pressure of public opinion has been effective. In the case of the African elephant, Tokyo could have sided with the nations that said their policies helped preserve elephant herds. Instead, Tokyo bowed to substantial worldwide pressure, even though the impact hit a traditional craft.

The country's advancement in the international arena has coincided with a growing attempt by nongovernmental organizations to draw attention to what they consider to be controversial practices. The shrinking acreage of rain forests and the link to global warming poses a twofold problem for Japan, which relies on imports from the forests but also is concerned with the potential problems connected to global warming. Although contending its role in the deforestation is small, Japan hopes to move the exporting nations toward sustainable forestry management and reforestation, partially through improvements in the environmental component of its foreign aid.

Tokyo's use of foreign aid to help resolve environmental problems points out the irony that until recently environmental concerns were unlikely to be considered in awarding developmental aid. But Japan is moving quickly toward increased recognition of its role as a leader through its financial strength and its domestic record of environmental improvements in such areas as CFCs (see JEI Report No. 1A, January 5, 1990). Having moved beyond a pioneer status, Tokyo is at a stage where politically and financially it can help shape environmentally responsible policies that most likely will work toward sustainable development as its goal.

For further information, contact Pat Murdo.

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The views expressed in this report are those of the author and do not necessarily represent those of the Japan Economic Institute.

APPENDIX

Table 1: Japan's Wood Imports By Country

(in millions of dollars* and composition)

Year	Total	Indonesia	Malaysia	Philippines	United States
1965	$492.5	$3.4 (0.7%)	$86.0 (17.5%)	$154.3 (31.3%)	$137.6 (27.9%)
1970	1,572.1	176.4 (11.2)	188.8 (12.0)	264.9 (16.8)	517.8 (32.9)
1975	2,620.6	361.3 (13.8)	300.4 (11.5)	160.6 (6.1)	1,061.4 (40.5)
1976	3,531.9	682.6 (19.3)	687.7 (19.5)	145.1 (4.1)	1,170.7 (33.1)
1977	3,802.6	703.4 (18.5)	661.7 (17.4)	150.5 (4.0)	1,239.6 (32.6)
1978	4,135.2	716.2 (17.3)	784.5 (19.0)	172.3 (4.2)	1,358.2 (32.8)
1979	7,353.2	1,534.5 (20.9)	1,575.0 (21.4)	242.0 (3.3)	2,297.1 (31.2)
1980	6,909.0	1,404.4 (20.3)	1,250.7 (18.1)	258.0 (3.7)	2,170.0 (31.4)
1981	4,459.1	641.7 (14.4)	996.9 (22.4)	237.6 (5.3)	1,433.7 (32.1)
1982	4,546.1	458.0 (10.1)	1,326.6 (29.2)	249.6 (5.5)	1,371.1 (30.2)
1983	3,886.8	332.6 (8.6)	1,144.0 (29.4)	135.3 (3.5)	1,181.5 (30.4)
1984	3,909.1	268.4 (6.9)	1,236.6 (31.6)	184.7 (4.7)	1,103.6 (28.2)
1985	3,699.6	136.1 (3.7)	1,179.2 (31.9)	121.8 (3.3)	1,129.4 (30.5)
1986	4,028.7	114.7 (2.8)	1,180.6 (29.3)	74.7 (1.9)	1,323.5 (32.9)
1987	6,226.5	203.5 (3.3)	2,090.9 (33.6)	79.1 (1.3)	1,960.9 (31.5)
1988	7,122.2	301.6 (4.2)	1,852.6 (26.0)	104.8 (1.5)	2,452.3 (34.4)

*The following average annual exchange rates were used to convert the yen import figures to dollars: 1965, Y360.00; 1970, Y360.00; 1975, Y296.69; 1976, Y297.01; 1977, Y270.53; 1978, Y212.17; 1979, Y217.46; 1980, Y227.85; 1981, Y219.94; 1982, Y248.30; 1983, Y237.59; 1984, Y236.91; 1985, Y240.17; 1986, Y170.08; 1987, Y146.01; and 1988, Y128.15.

Source: Japan Tariff Association

Table 2: Japanese-Funded Foreign Forest Conservation Projects

Recipient	Technical Cooperation	Grant Aid	Development Survey
Philippines	Forestry development in Pantabangan (1976-1987 and 1987-1992)	Construction of forestry training center (1978) Fire-fighting system in Pantabangan (1984)	
Indonesia	Reforestation in South Sumatra (1979-1988)	Research center on reforestation (1979)	

Recipient	Technical Cooperation	Grant Aid	Development Survey
Malaysia	Training for reforestation engineering in Sabah (1987-1992)		
Papua New Guinea		Construction of national forest research center (1987)	
Thailand*			National forest management project (1984-1988)
Burma		Training center for forestry development (1987)	
China*		Reconstruction of forest fire damage in Daxinganling (1987)	
Brazil	Forestry research in San Pablo (1979-1986)		
Paraguay	Afforestation project in center of country (1987-1992)		
Ecuador			Forestry research in northeast area (1984-1988)
Senegal		Forest fire prevention project (n.d.)	
Nigeria			Forest conservation and development of semi-arid areas (1986)
Kenya	Forestry training for developing seedlings (1985)	Forestry training center for developing seedlings (1986)	
Tanzania			Forestry project on Kilimanjaro (1985-1988)

*Not listed are recent grant aid to Thailand and to China for environmental conservation centers.

Source: Ministry of Foreign Affairs, Japan's Approach to Environmental Issues of the Globe, September 1989.

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REPORT

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THE LONG WORKWEEK IN JAPAN: DIFFICULT TO REDUCE

Summary

Almost four years have passed since the Japanese government first recommended that the long hours put in by the country's labor force, regarded as one of the causes of its chronically huge trade surplus, be reduced to less than 2,000 a year. Through the 1980s the number of hours the typical Japanese worker spent on the job each year topped the comparable figures for other major industrialized countries by a big margin. Time spent working leaves less leisure time and, it is argued by some, holds down consumer spending and imports.

Despite widespread expectations in the 1970s, a drop in the number of hours worked did not happen in the last decade. During the period of slower economic growth after the twin oil shocks of the 1970s, many workers opted for higher wages rather than shorter hours. At the same time businesses -- particularly small and medium-sized companies -- tried to increase sales by producing more, and they did this primarily through longer working hours rather than more efficient use of their work force. In addition, the high cost of leisure in Japan, the six-day school week for children, the small size of most Japanese homes and other factors encouraged people to work long hours.

Moves toward a five-day workweek, less overtime and more paid leave, considered key to reducing hours on the job, advanced briefly in the mid-1980s, but the amount of paid leave taken has declined again. Recent efforts by the Ministry of Labor to promote a shorter workweek reportedly have met with little success. Japan appears to have a long way to go before becoming a member of the American and European workweek club.

Japan Economic Institute 1000 Connecticut Avenue, N.W., Washington, D.C. 20036 202·296·5633

Overview

The Ministry of Labor, which calculates how much time people in Japan work each year based on monthly employment statistics, estimates that the average number of working hours peaked at 2,432 in 1960 and then dramatically decreased in the 1960s and the first half of the 1970s to 2,064 in 1975. But, in a sudden, surprising reversal, the figure climbed to 2,100 hours in the late 1970s and stayed close to that number through the 1980s. The 1975 record low has not been broken in the past 14 years, even though Japan's gross national product more than doubled over the same period. Economists expected a reduction in the hours worked to follow naturally from the expansion of the Japanese economy as these gains were distributed through either wage hikes, fewer working hours and/or higher profits. Working hours typically have decreased in European countries in parallel with economic growth.

Table 1 shows a fluctuation of only 22 hours between the highest and the lowest number of hours worked a year (including both scheduled and overtime hours) during the 1976-88 period. Scheduled work peaked at 1,956 hours per employee in 1979 and then gradually declined to 1,933 hours in 1987 and 1,898 last year as more companies (77.6 percent of firms surveyed in 1987 versus 71.3 percent in 1976) switched to a five-day workweek. However, this drop was offset by an increase in overtime from 139 hours in 1976 to 190 hours in 1989. As a

Table 1: Working Hours in Japan, 1975-89*

Year	Total	Scheduled	Overtime
1975	2,064	1,937	127
1976	2,094	1,955	139
1977	2,096	1,952	144
1978	2,102	1,955	147
1979	2,114	1,956	158
1980	2,108	1,946	162
1981	2,101	1,940	161
1982	2,096	1,939	157
1983	2,098	1,937	161
1984	2,116	1,945	171
1985	2,110	1,932	178
1986	2,102	1,930	172
1987	2,111	1,933	178
1988	2,111	1,922	189
1989	2,088	1,898	190

*Based on Ministry of Labor survey of companies with 30 or more regular workers. Part-time workers are excluded from the survey, as are workers in the agricultural and the forestry sectors and public-sector employees.

Source: Ministry of Labor

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result, the number of hours the average Japanese spends on the job in a year has remained almost constant.

International Comparison

An accurate international comparison of annual working hours is difficult because different countries use different methods to compute the statistics. The only common indicators are scheduled and overtime hours worked in a week. Annual hours then are obtained by multiplying the average workweek by 52 and subtracting weekends, national holidays, paid leave and other absences. According to Labor Ministry estimates, the number of hours worked in Japan's manufacturing sector averaged 2,168 in 1987 -- 219 more than in the United States and a whopping 526 hours above the comparable West German figure (see Table 2).

Table 2: International Comparision of Manufacturing Working Hours, 1987

(in days except for total hours worked)

	Total Hours Worked	Nonwork Weekends	National Holidays	Paid Leave	Other Absence
Japan	2,168	85	19	9	3
United States	1,949	104	11	19	6
United Kingdom	1,947	104	8	23	n.a.
France	1,645	104	8	26	16
West Germany	1,642	104	12	29	16

Source: Ministry of Labor

The main discrepancy arises from the higher number of nonwork weekends and paid days of leave in competitor countries. The length of the scheduled workday, calculated by dividing the annual figure by the number of workdays in a year, does not show much difference by country -- 8.1 hours in Japan, 8.13 hours in the United States and 8 hours in West Germany. The same is true for overtime, with Japanese employees averaging 0.93 hour a day in 1987 compared to 0.89 hour for Americans. West German workers put in less than half the overtime (0.4 hour) that Japanese employees did, but on an annual basis the difference in overtime, 146 hours, explains only one-fourth of the divergence in total hours worked a year by the West German and the Japanese labor forces.

Variations in the total number of days worked by full-time employees explain much of the difference. MOL bases the four Western countries' figures on a five-day workweek and paid leave of about 20 days. The distinctive characteristic for Japan is that workers have fewer days off -- part of Saturday, all-day Sunday, paid leave days and other days of absence. For instance, a typical Japanese manufacturer provides only 85 weekend days off or just 81.7 percent of the Saturdays and Sundays in a year. Moreover, the average Japanese manufacturer gives 9 days of paid leave compared to 19 days for the normal American business and the 23 to 29 days offered by European companies. On the other hand, Japan's 19 national holidays contrast with the 11 days celebrated by most American firms and the 8 to 12 days set aside by European companies.

1,800 Hours Set as Annual Goal

Facing serious trade friction with the United States and Europe in the early 1980s, the Japanese government established a special committee in 1985 to recommend specific long-term goals that would help Japan deal harmoniously with industrialized as well as developing countries. That committee was the Advisory Group on Economic Structural Adjustment for International Harmony, but it is better known as the Maekawa Commission after its chairman, Haruo Maekawa, former president of the Bank of Japan. One major point of the group's report, submitted in early April 1986 to then Prime Minister Yasuhiro Nakasone, called for reducing working hours to stimulate personal consumption, which, in turn, would raise the standard of living in Japan and, presumably, trim the country's trade surplus.

The report urged the private sector to bring working hours per year into line with those of European countries and the United States, particularly through early implementation of a five-day workweek. Similar efforts should be made in the public sector, the report said. It also encouraged workers to take more of their paid leave. Based on these recommendations, the government included in its five-year economic plan, announced in late May 1988, a clearly set national goal of 1,800 working hours a year by 1992. To reach this goal the government advocated a 40-hour workweek, based on eight hours of scheduled work a day over the five weekdays.

Before setting 1,800 hours as the national goal the Economic Planning Agency analyzed 1987's average of 2,111 working hours. EPA found that scheduled hours actually ran 7 hours 25 minutes, 35 minutes less than the standard 8 hours, and that overtime averaged 40 minutes a day. If 1987's actual nonworking weekends of 79 days and paid leave of 8 days were increased to 104 days and 20 days, respectively -- similar to what other advanced countries provide -- the number of workdays in a year would be reduced by 37 to 223, leaving the 15 national holidays and the three other absent days constant. (Workers in the manufacturing sector get more national holidays than employees in other parts of the economy.) Multiplying 7 hours 25 minutes and 40 minutes by 223 days yields about 1,654 scheduled hours of work and 149 overtime hours for a yearly total of 1,803 hours. Therefore, by implementing a five-day workweek and providing 20 days of paid leave, EPA figured that Japan could achieve increased leisure time with 1,800 hours of work a year.

Progress of Five-Day Workweek

Even before the five-year plan announced in 1988, the Economic Council, attached to the prime minister's office, had suggested a goal of 1,800 working hours in a mid-May 1987 report on structural adjustment. Based on this recommendation, the Ministry of Labor in September that year revised the Labor Standards Law, which regulates weekly working hours in the private sector, and recommended an upper limit of 40 hours of work a week. In practice, though, the law recognizes 46 hours a week as legally permissible. The administration backed off from the 40-hour limit as too hard for small and midsized companies to implement immediately and suggested the 40-hour week be introduced gradually, taking into account the potential impact on the economy.

According to MOL's plan, a 44-hour limit for nonfinancial private companies will be introduced in 1991 before the ceiling drops to 40 hours in 1993. For government employees the 44-hour workweek went into effect at the start of 1989, allowing civil servants to take every other Saturday off. Financial institutions, such as banks and brokerage houses, moved to a five-day workweek starting in February 1989.

Because of these changes, the Labor Ministry said at the end of January, the number of working hours in 1989 decreased by 23 to 2,088 hours. In particular, scheduled hours dropped to 1,898 -- the first time that figure had fallen below the 1,900-hour level -- reflecting the move toward a five-day workweek by the government and financial organizations. Although overtime reached a record high of 190 hours last year (attributable to Japan's third-longest economic expansion), the decline of 23 hours in the combined tally was the biggest since 1975. However, to reach the goal of 1,800 working hours a year by 1993, time on the job must be cut by another 288 hours, or 96 hours a year, over the next three years.

Small and midsized companies are the main bottleneck to a five-day workweek. The 1989 white paper on labor pointed out that in 1987 only 5.2 percent of companies employing 30 to 99 people had switched to a five-day workweek compared to 49.9 percent of firms with a work force of 1,000 or more. However, this figure looks much better than the estimate made last year by a business association for small and medium-sized companies. That survey, released in mid-December, indicated that just 1.8 percent of the group's members had gone to a five-day workweek. It also revealed that only 37.1 percent of the surveyed companies planned to reduce working hours within the next three years; 62.1 percent of the firms replied "no plan" or "not decided."

Small businesses, which have been hit the hardest by labor shortages brought about by the current economic boom, generally have put much more emphasis on higher wages than on shorter working hours. They point to the effect on relations with customers and suppliers and the impact on sales as the main obstacles to implementing a five-day workweek. Management factors, such as the shortage of workers and managers, count less in their opposition.

In addition to management's reluctance to grapple with the problem of cutting working hours, the labor movement has not made a shorter workweek a bargaining priority. Until last year no major trade union had demanded a reduction in the number of hours worked. Through the late 1970s and the early 1980s unions considered wage increases to be more important than fewer hours on the job, especially when economic growth slowed after the second oil crisis.

In a 1988 report a Labor Ministry advisory group broke down productivity gains in different countries and showed that in Japan 0.6 point of the average annual productivity growth of 2.3 percent in the 1980s went to profits and 1.7 points to wage increases with no change in working hours. In West Germany, however, the 1.8 percent average yearly rise in productivity was divided among higher profits (1.1 points), increased wages (0.2 point) and shorter working hours (0.5 point). The results were similar in France, where the 2.8 percent gain was divvied up 0.5 point for profits, 1.2 points for wages and 1.1 points for working hours.

There are several reasons why Japanese workers have not been interested in working less. Some analysts point to the traditional work ethic in Japan, which equates work with virtue and leisure with undesirable behavior. However, this philosophical interpretation plays a very minor role in explaining the situation today. A fundamental reason Japanese workers do not push for a five-day workweek or more paid leave, it appears, is because the infrastructure for leisure is inadequate.

For example, a scarcity of sports facilities, like tennis courts or pools, narrows the opportunities for weekend exercise. Moreover, if the facilities are privately operated, they are much more expensive than in the United States or elsewhere overseas. Free local or national parks also are in short supply. When parents want to take their children out for entertainment, choices are limited to very expensive amusement parks like Tokyo Disneyland or movies. Driving is costly because of high gasoline prices and high charges for toll expressways. Recreational shopping also is costly given Japan's generally high prices.

From these and other examples many Japanese conclude that it is too expensive to go out on the weekends. And even if they are inclined to go out and spend money on recreation, pandemic congestion makes them think twice. As a result, numerous Japanese prefer to stay at home and watch television, listen to music or read, but because houses and apartments in Japan have been described as "rabbit hutches," spending more time at home often is not much of an attraction. In short, high leisure costs, inadequate leisure infrastructure and cramped quarters are all disincentives to shorter working hours.

Paradoxically, many Japanese also have not learned how to enjoy the weekend because the five-day workweek is such a recent phenomenon. Another factor is that since children go to school on Saturday mornings in Japan, a family cannot go away until school is out even if the parent has Saturdays off. When polled in 1986 by the Prime Minister's office, 62.3 percent of the households surveyed supported the current extended school week. Their first concern was that children might not learn enough if the school week were limited to five days or that the competitive skills needed to pass difficult entrance examinations -- required for prestigious kindergartens as well as top universities -- would not be honed adequately. According to a 1986 government survey, 20 percent of the parents responding answered that they would send their children to a weekend private cram school if regular schools were closed on Saturdays. Many educators, especially school principals, support these concerns. They also point out that schools would need more playgrounds and sports facilities if they had to condense all activities into five school days. All these elements work against fewer hours on the job.

Paid Leave

The average amount of paid leave provided each year in Japan varies by the size of the company, ranging from 13.1 days for small firms to 17.1 days for large corporations with midsized companies at 14.5 days. These numbers changed very little in the 1980s. Between 1980 and 1988 employees of small businesses got an extra day off, people working for medium-sized firms received 0.7 day more and the work force at large corporations was given an additional 0.5 day off.

Fewer Japanese, however, were taking all the paid leave to which they were entitled at the end of the decade than at the beginning. At small companies the ratio dropped from 58.6 percent in 1980 to 48.9 percent in 1988, while at midsized firms it fell from 60.9 percent to 49 percent and at big operations from 62.7 percent to 51.5 percent. This meant that the actual amount of paid leave taken by employees of small companies declined from 7.1 days in 1980 to 6.4 days in 1988; the comparable figures from medium-sized firms were 8.4 days and 7.1 days and those for large business were 10.4 days and 8.8 days. The problem with paid leave is much more serious than that of the five-day workweek because of this drop in usage in recent years.

Almost the same reasons apply to paid leave that affect the five-day workweek. Furthermore, many workers have told pollsters that they do not have the freedom to take long vacations, even when top management suggests they do. They say that the importance of maintaining relations with business colleagues or suppliers virtually keeps them from taking more than three days of vacation. A worker who takes longer leaves is suspected of thinking that the job or the business relationship is unimportant. Polled workers who receive six days of paid leave or less a year say that they fear taking time off would cause troubles for their colleagues. Other answers revolve around a similar theme: the office atmosphere does not encourage being away from the job; the boss is reluctant to allow people to take their leave; and a worker will lose esteem by taking time off. Since sick leave usually is included in the total number of days of paid leave, the second-largest response is that workers want to keep their leave in reserve for illness or unavoidable errands.

Japanese commonly use three days of paid leave at a time to go traveling, either domestically or overseas. According to 1984 estimates by the Ministry of International Trade and Industry, average daily expenditures by Japanese families for vacations or traveling were Y17,900 ($127.86 at Y140=$1.00), four times higher than the Y4,300 ($30.71) spent in France and six times the Y3,100 ($22.14) figure for West Germany. The high cost for the vacationing Japanese family primarily relates to the lack of infrastructure and high prices in Japan. An interesting survey by a Japanese insurance company in 1988 compared how much Japanese businessmen and foreign businessmen in Japan would pay for a one-week vacation if they had to buy time off from their company. The average figure for the Japanese respondents was Y71,047 ($507), whereas foreigners would go as high as Y262,700 ($1,876). This shows how much lower Japanese workers seem to rate paid time off than people in other countries. For various economic and cultural reasons, neither workers nor management considers paid leave to be an essential aspect of work life in Japan.

Overtime Working Hours

Overtime is on the rise in Japan. While the average number of extra hours workers put in each year dropped from 200 in 1970 to 127 in 1975, overtime headed up again in the last decade, reaching 162 hours in 1980, 178 in 1985 and 190 in 1989. The increases in the last two years can be explained partly by the economic boom, but that explanation does not work for the rest of the 1980s.

The most probable economic reason for the rise in overtime is the cost differential between hiring new employees and having existing workers put in extra hours to meet an increased demand for labor. The 1990 economic white paper sheds light on this gap. The average hourly cost of a new hire in the manufacturing sector is estimated to be Y2,340 ($16.71). If, however, workers already on the payroll work more than their scheduled hours, the average hourly cost decreases in parallel with the number of overtime hours, such as Y2,330 ($16.64) for five overtime hours down to Y2,290 ($16.36) for 30 hours under the current payment system for overtime. Therefore, it is less expensive for management to get the additional labor needed through overtime than by hiring new employees.

In Japan the rate for overtime is set at 25 percent more than the payment for regular hours. Many economists argue that this premium is too small to discourage employers from using overtime to meet the demand for extra labor. They add that the incentive to hire more workers would expand if overtime were paid at time-and-a-half as it is in the United States or even a higher rate. This proposal, however, faces strong opposition from Japanese management since it would increase the cost of doing business. Adjusting the number of employees on the payroll in response to the ups and downs of the business cycle is very hard, business leaders contend. It is particularly difficult to lay off workers during an economic downturn because lifetime employment is expected by full-time employees in big Japanese companies.

Employees also factor in overtime as part of their total annual pay, and they do not want to reduce overtime to the extent that their financial plans, such as buying a house or traveling, would be disrupted. Unconvinced of the benefits of leisure and aware of its cost, both employees and employers are reluctant to cut hours. While the 190 hours of overtime put in by the average worker in 1989 was a record, economists do not expect the amount of overtime to keep rising in the future. As the current economic boom begins to lose some of it steam, they note, overtime will decrease. But labor experts add that there are no grounds for optimism about a drastic reduction in overtime without a significant change in the underlying economic rationale.

Economic Impact of Reducing Working Hours

Some estimates of the economic impact of reducing working hours in Japan are available. The Economic Planning Agency, for example, has estimated how much consumption would increase if the five-day workweek became standard practice. Its initial report, released last October, indicated that the addition of one nonworking day a year would boost the average propensity to consume by 0.059 percent, while a switch to a five-day workweek would raise annual spending per household by Y59,433 ($424.52). (In 1988 the average Japanese household spent about Y3.5 million or $25,000.) Multiplying Y59,433 by the 28.72 million households in Japan puts the national annual increase in consumer spending at about Y1,706.9 billion ($12.2 billion).

Further refining its work, EPA predicted last November that yearly household spending would go up Y58,000 ($414.29) with the introduction of a nationwide five-day workweek and Y81,000 ($578.57) by combining 20 days of paid leave with a five-day workweek. At the aggregate level these two scenarios worked out to a projected gain in consumption of Y1.6 triliion ($11.4 billion) and Y2.2 trillion ($15.7 billion), respectively. Using a Keynesian multiplier, EPA estimated that total national output would expand by Y3 trillion ($21.4 billion) a year if a five-day workweek were adopted and by Y4.1 trillion ($29.3 billion) if workers also were given 20 days of paid leave a year. (Japan's 1988 gross national product in current prices totaled Y367.4 trillion or $2.6 trillion.)

The EPA reports did not calculate the impact of a five-day workweek or more paid leave on Japan's trade surplus, but EPA economist Soji Kimura, using the 1987 national income account, privately has estimated that if the typical Japanese worker put in 100 fewer hours a year, the trade surplus, which totaled Y8.9 trillion/$64.4 billion in 1989, would be cut by Y4 trillion ($28.6 billion). Last year's exports of Y37.8 trillion/$275.2 billion would be reduced by Y1.7 trillion ($12.1 billion) and imports, at Y29 trillion/$210.7 billion, increased by Y2.3 trillion ($16.4 billion), according to Mr. Kimura, who was quoted in a recent issue of the Japanese weekly, Economist. This implies that if annual working hours in Japan are reduced to the goal of 1,800 within a few years, about 90 percent of Japan's current overall trade surplus would disappear.

Conclusion

A MITI advisory group recently released a new indicator of labor productivity that underscores the cost of long working hours. In an early February report the group disclosed that hourly productivity in Japan (GNP per capita divided by the average number of working hours a year) is lower than that of other advanced countries -- 71.3 percent of the U.S. figure, 73.9 percent of France's and 76.8 percent of West Germany's. The lower hourly productivity statistic for Japan is the result of the long hours Japanese workers put in, the group said. It suggested that the government provide tax and other financial incentives for small companies to shorten the workweek. The report emphasized that fewer working hours do not decrease but rather increase labor productivity. The Labor Ministry has said it supports this argument based on its finding that a 1 percent reduction in working hours increased productivity 0.9 percent from 1968 to 1984.

The slow pace at which change is occurring in Japan in the length of the workweek, the amount of paid leave and the number of hours of overtime has caused frustrations to accumulate. Former Keio University Professor Kotaro Tsujimura recently advocated that corporations should be legally required to reduce working hours because neither the market mechanism nor goodwill has been effective. Whether his prescription is the right one is unclear. But without some drastic reform or change it certainly will take a long time to cut working hours, which are deeply rooted in the structure of the Japanese economy as well as in the historical and cultural background of Japanese society.

For further information, contact Hideo Takahashi.

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The views expressed in this report are those of the author and do not necessarily represent those of the Japan Economic Institute.

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JAPAN · ECONOMIC · INSTITUTE

JEI REPORT

A Two-Part Report: A and B

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IN THIS ISSUE:

Japan's Economy Facing New Problems? 1

Technology Flowing From Japan 3

Administration Briefs Senate On SII Talks 4

Dialogue Continues On Host-Nation Support 6

Notes: NTT Reorganization; TSE Membership;
Retirement Age; Forklifts; Steel 7

Statistical Supplement 11

Japan's Economy Facing New Problems?

Japanese analysts sometimes have described Japan's economy since the Plaza Accord in September 1985 as enhanced by so-called triple merits: low interest rates, cheap oil and a strong yen. Together these forces were said to accelerate Japan's rate of economic expansion. Four and a half years later some analysts say the ground has shifted, with at least some of these advantages becoming disadvantages.

Tokyo could do little in late 1985 to guarantee cheap oil, but the other elements were under its influence, if not control. Falling oil prices and other factors in 1985 and early 1986 led the current account surplus higher, and oil prices and the chronic current account surplus together helped strengthen the yen during this period. To prevent runaway appreciation of the yen the Bank of Japan bought dollar-denominated securities for much of the period between September 1985 and April 1989, thereby increasing the demand for dollars and the supply of yen. This latter action, which added to Japan's foreign exchange reserves, tended to increase the money supply.

Steel - Nearly six months after the Bush administration's steel restraint program went into effect, nine of the 17 country participants (South Korea and Brazil plus seven swing suppliers) still have not signed the new arrangements. This delay has extended the news blackout on the specifics of the individual pacts, each of which includes an agreement to end practices that distort world trade in steel (see JEI Report No. 47B, December 15, 1989). With the late February signing of the voluntary restraint agreement negotiated with Japan, however, the Department of Commerce has released the details of how much steel this country's number-two foreign supplier can ship to the United States during the October 1989-December 1990 period, the first of two 15-month quota periods. The outlines of the VRA had been disclosed previously, including the fact that only Japan had its shipment ceiling lowered, but the Commerce document spells out how this cut has been allocated across product lines.

Export Ceiling on Japanese Steel, October 1989-December 1990

	Share of U.S. Apparent Consumption		New Ceiling
Product Category	Old VRA	New VRA	(metric tons)
Semifinished Steel	*	0.088%	94,782
Plate	0.60%	0.990	63,902
Sheet and Strip	5.57	5.730	3,214,115
Cold-Rolled Sheet and Strip	4.59	4.590	751,934
Coated Sheet and Strip	12.04	11.690	1,767,674
Electrogalvanized	****	16.390	444,866
Electrical Sheet and Strip	6.23	6.670	37,335
Tin Plate	5.53	5.790	188,855
Tin-Free Steel	6.27	6.620	71,893
Bar	1.50	0.600	89,999
Cold-Finished Bar	4.54	2.000	32,940
Stainless Bar	***	10.470	17,171
Wire Rod and Wire Products	6.71	6.030	484,752
Wire Rod	5.93	5.930	353,932
Stainless Rod	***	10.440	7,151
Structural Shapes	8.52	7.110	708,405
Rail and Rail Products	10.25	9.560	94,309
Fabricated Structurals	*	**	50,453
Welded H-Beams	****	**	30,000
Pipe and Tube	13.26	8.650	640,965
Oil-Country Tubular Goods	17.56	9.660	151,734
Line Pipe	15.52	15.520	292,630
Structural Pipe	24.18	12.000	67,620
Alloy Tool Steel	***	5.890	5,684
Total	6.19	5.000	5,737,629

*Previously restrained on a volume basis, not as a share of U.S. apparent consumption.

**Currently restrained on a volume basis, not as a share of U.S. apparent consumption.

***New category. These products previously were restrained under a specialty steel orderly marketing agreement that expired in September 1989 and could not be renewed.

****New subcategory.

Source: Department of Commerce

STATISTICAL SUPPLEMENT

Trade and Payments Data

(in millions of dollars unless otherwise indicated)

	1987	1988	January-December 1988	January-December 1989	October 1989	November 1989	December 1989
Japan's Balance of Payments							
Trade Balance	$96,386	$95,012	$95,012	$77,130*	$5,461*	$4,493*	$6,301*
Exports (f.o.b.)	224,605	259,765	259,765	269,631*	22,370*	21,606*	23,993*
Imports (f.o.b.)	128,219	164,753	164,753	192,501*	16,909*	17,113*	17,692*
Current Account Balance	87,015	79,631	79,631	56,975*	3,589*	4,264*	3,818*
Long-Term Capital (net)	-136,532	-130,930	-130,930	-87,928*	-25,477*	-7,866*	3,387*
Overall Balance	-29,545	-28,982	-28,982	-33,286	-36,866	231	7,348
International Reserves (end of period)	81,479	97,662	97,662	84,895	84,293	84,747	84,895
Japan's Customs Clearance Trade							
Trade Balance	79,706	77,563	77,563	64,328	4,651	3,527	6,208
Exports (f.o.b.)	229,221	264,917	264,917	275,175	23,019	22,077	24,655
Cars	35,693	38,671	38,671	38,820*	3,142	3,161	3,152*
Steel	12,610	15,322	15,322	14,791*	1,164	1,046	1,318*
Imports (c.i.f.)	149,515	187,354	187,354	210,847	18,368	18,550	18,446
Crude Oil	20,663	18,852	18,852	21,539*	1,715	2,042	2,381*
Manufactured Products	65,961	91,838	91,838	106,110*	9,542	9,403	9,177*
Japan-U.S. Trade							
Trade Balance	52,090	47,597	47,597	45,002*	3,828	3,562	3,831*
Exports (f.o.b.)	83,580	89,634	89,634	93,186*	7,918	7,656	7,755*
Imports (c.i.f.)	31,491	42,037	42,037	48,184*	4,090	4,094	3,924*
Yen-Dollar Exchange Rate (average for period)	Y144.64	Y128.15	Y128.15	Y138.00	Y141.93	Y143.52	Y143.60
U.S. Trade							
Trade Balance	-152,119	-118,526	-118,526	-108,576*	-11,498	-10,562	-6,409*
Exports (f.a.s.)	254,122	322,426	322,426	364,350*	31,906	30,352	31,183*
Imports (Customs)	406,241	440,952	440,952	472,926*	43,404	40,913	37,591*
U.S.-Japan Trade							
Trade Balance	-56,326	-51,794	-51,794	-49,002*	-4,907	-4,000	-3,485*
Exports (f.a.s.)	28,249	37,725	37,725	44,584*	3,724	3,752	4,073*
Imports (Customs)	84,575	89,519	89,519	93,586*	8,631	7,752	7,558*

*Preliminary

STATISTICAL SUPPLEMENT

Japanese Economic Indicators

(percent change from year-earlier period unless otherwise indicated)

	1987	1988	January-December 1988	January-December 1989	October 1989	November 1989	December 1989
Discount Rate (end of period)	2.5%	2.5%	2.5%	4.25%	3.75%	3.75%	4.25%
Outstanding Money Supply	10.4%	11.2%	11.2%	9.9%	9.6%	9.9%	10.6%
Industrial Production	3.4%	9.5%	9.5%	6.0%	5.5%	3.6%	3.1%
Manufacturing Operating Rate	0.1%	5.9%	5.9%	2.3%	2.1%	0.1%	-0.7%
Number of Bankruptcies	-27.6%	-20.0%	-20.0%	-28.4%	-33.3.%	-36.9%	-40.0%
Residential Construction Starts	22.7%	0.6%	0.6%	-1.3%	2.8%	3.2%	0.6%
Job Openings to Applications (ratio)	0.70	1.02	1.02	1.26	1.30	1.32	1.32
Nominal Wages	1.9%	3.8%	3.8%	4.7%	3.7%	5.6%	5.7%
Manufacturing Labor Productivity	5.8%	11.5%	11.8%*	7.1%*	3.3%	n.a.	n.a.
Wholesale Prices	-3.7%	-1.0%	-1.0%	2.5%	3.3%	3.8%	3.9%
Consumer Prices	0.1%	0.7%	0.7%	2.3%	2.9%	2.3%	2.6%
Yen-Based Export Prices	-5.1%	-2.2%	-2.2%	4.4%	4.4%	7.0%	7.2%
Yen-Based Import Prices	-8.3%	-4.6%	-4.6%	7.7%	9.2%	14.8%	15.3%

*Through October of each year only.

For Japan's latest GNP figures, see JEI Report No. 47B, December 15, 1989.

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REPORT

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JAPANESE POLITICS: A SYSTEM IN TRANSITION?

Summary

The ruling Liberal Democratic Party's losses to the Japan Socialist Party in last July's upper house elections prompted widespread speculation that Japanese politics were on the threshold of a new era. Further proof of a restructuring of the LDP-dominated political system would be apparent when elections were held for the more powerful Diet lower house, pundits maintained. Although the electorate gave the ruling party a sound victory in last month's House of Representatives contests and, in turn, ensured the continuation of a LDP-led government, political change remains a possibility. The election outcome suggests that, while the Japanese people still believe the LDP is more capable of governing than the inexperienced, fractured political opposition, voters are becoming less convinced that the ruling party's style of politics and policies are responsive to their interests and needs.

The losses incurred by the smaller noncommunist opposition parties in both the upper and the lower house elections, against a backdrop of Japan Socialist Party gains, may indicate the beginning of a gradual transition to a U.S.-style two-party system. The challenge for the JSP during this period will be to attract candidates who can inspire voter confidence in the Socialists' governing abilities as well as to revamp the party's platform to be more relevant to Japan's emerging global leadership position.

The new administration of Prime Minister Toshiki Kaifu enters the scene faced with problems not known to recent Japanese governments. With the opposition parties dominant in the upper house, the former education minister will have to forge a working

coalition with at least one of these groups to ensure enactment of potentially contentious legislation that the Diet is expected to consider this year. Moreover, Mr. Kaifu may have to undertake this formidable task while contending with his own party's internal shake-up.

The Lower House Elections: Ruling Party Rebound?

After a year marked by political scandals, leadership resignations and a crushing defeat in the July 1989 upper house elections, members of the ruling Liberal Democratic Party pulled out the stops in campaigning for the February 18 lower house elections. Their hard work paid off. The LDP captured approximately 47 percent of the popular vote, only slightly below the percentage won in July 1986 when the ruling party gained a record 300 lower house seats.

After all of the votes were counted, the LDP won 275 of the 512 seats in the House of Representatives; conservative independents subsequently aligned with the Liberal Democrats to bring their official tally to 286 seats (see Tables 1-2). This figure is well in excess of the 271 seats the party needed to retain control of all committees in this chamber -- what in Japan is called a "stable" majority. A win of 257 seats, or a simple majority, would have ensured the election of a LDP prime minister. However, because a party is granted the same percentage of seats on each panel as it enjoys in the lower house as a whole, the LDP would not have controlled all the committees. On a 50-member panel, for example, a party would need at least a 26-member presence (since the chairman does not vote) to dominate the proceedings, which, in turn, would require a lower house majority of over 50 percent. If the LDP had won only 267

Table 1: February 18, 1990 Lower House Election Results

Party	Seats After July 1986 Elections	Seats When Diet Dissolved January 1990	Seats After February 1990 Elections
Liberal Democratic Party	300	295	286
Japan Socialist Party	85	83	141
Komeito	56	55	46
Japan Communist Party	26	27	16
Democratic Socialist Party	26	26	14
United Social Democratic Party	4	4	4
New Liberal Club	6	0	0
Progressive Party	0	1	1
Independents	9	4	4
Total	512	495*	512

*17 seats were vacant at the time of the February 18 elections.

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Table 2: Status of Winning Lower House Candidates

Party	Incumbents	Former Office Holders	New	Total
Liberal Democratic Party	228	5	53	286
Japan Socialist Party	65	16	60	141
Komeito	35	0	11	46
Japan Communist Party	10	2	4	16
Democratic Socialist Party	8	3	3	14
United Social Democratic Party	4	0	0	4
Progressive Party	1	0	0	1
Independents	2	0	2	4
Total	353	26	133	512

seats, what the Japanese call a "dominant" majority, it would have controlled the influential budget committee.

Thus, had the February elections reduced the LDP's majority to less than 271 seats, the ruling party would have had little choice but to form a coalition with at least one of the opposition parties in order to facilitate legislative action. Preelection polls by Asahi Shimbun indicated that some 45 percent of the Japanese people in fact favored roughly equivalent wins by the ruling party and the opposition parties as a group. But with a field divided among 720 party-affiliated candidates, of which 320 were running on the LDP ticket, chances were slim that the vote would balance out given the multiseat representational system in the lower house. The LDP's solid 275-seat win means that the party will extend its 35 years of uninterrupted leadership into the near future.

Playing it safe - The LDP had a lot riding on the elections. It already had lost control, for the first time since the party was founded in 1955, of the Diet's upper house. When the polls closed after those July 23, 1989 elections, the LDP's 142-seat presence in the 252-seat House of Councillors had been reduced to 109 seats, while the Japan Socialist Party's tally had climbed to its highest yet, 73 seats (see Table 3). When the JSP total is combined with that of the other non-LDP parties, the political opposition can count on a 142-seat majority in this chamber (see JEI Report No. 32A, August 18, 1989).

This loss represented a watershed in postwar Japanese politics. The upper house realignment, as will be discussed below, has forced and will continue to force the ruling party to work more closely with the political opposition in developing and enacting legislation. Nevertheless, no matter what party dominates the upper house, it is the party that controls the lower house that plays the key role in ruling Japan.

The Japanese constitution gives the lower house greater authority than the upper house in some important policy areas. As a result, the House of Representatives plays a leading role in the governing process. In the selection of a prime minister, for example, if there is a disagreement between the two chambers, the decision of the lower house prevails. Thus, as mentioned above, even with only 257 seats, the LDP could ensure that one of its own continues to lead

Table 3: Current Upper House Party Alignment

Party	Seats
Liberal Democratic Party	109
Japan Socialist Party	73
Komeito	20
Japan Communist Party	14
Democratic Socialist Party	10
United Social Democratic Party	0
Progressive Party	0
Rengo	12
Minor Parties	9
Independents	4
Total	251*

*One seat is vacant.

the country. In addition, all money bills first must be submitted to the lower chamber. If the two houses fail to reach an agreement on the budget or if no decision is made by the upper chamber within a month, the lower house-passed measure will prevail. Action by the House of Representatives on international treaties also will supersede a contrary judgment or inaction within 30 days by the House of Councillors. Finally, for all nonmoney bills, the lower house can override an upper house action by a two-thirds vote.

The electorate, of course, is aware that the lower house is the more important of the two chambers. The prevailing view among Japanese political commentators is that voters therefore used last summer's upper house contests to register discontent with ruling party politics and policies. Public disenchantment with the LDP's clubby, "smoky backroom" politics reached new heights as leading ruling party officials, one after another, were implicated in the Recruit Co., Ltd. influence-peddling scandal (see JEI Report No. 10A, March 10, 1989). This development added fuel to the dissatisfaction that already had been kindled in voters' minds by the LDP-led government's implementation of unpopular tax and import liberalization schemes. Many reacted by casting their ballots for JSP candidates, not so much as an endorsement of the Socialist Party but as a retaliatory tactic and anti-LDP statement. Moreover, since the upper chamber is the weaker of the two, voters could rest assured that the election results would not set in motion changes for which they were not quite ready.

When it came to selecting representation for the more powerful lower house, however, the Japanese people chose to play it safe and continued to entrust control of this chamber to the LDP. Professor Gerald Curtis of Columbia University maintains that the February 18 elections were a "vote of no-confidence in the opposition and a vote of confidence that the LDP is the best [the Japanese people] can get, given the options they were offered." Shuei Sai, one of a new breed of U.S.-style campaign consultants, concurs that voters were frustrated with the LDP old guard but anxious about any kind of left-wing coalition. While the issues that influenced the upper house contests -- Recruit, the 3 percent consumption tax and agricultural reform -- no doubt still affected voters' thinking in the election booths February 18, the overriding concern appeared to be whether a coalition led by the JSP could run the country. "They decided 'no,' that Japan's present stability, even with the excessive misbehavior of the ruling party, was better than the formidable uncertainties such a change would bring," Ms. Sai maintains.[1]

Perhaps the most striking evidence of voters' willingness to tolerate the LDP's "misbehavior" was in their reelection of virtually all of the senior ruling party officials who in some way were implicated in the Recruit affair (see Table 4). Former Prime Minister Noboru Takeshita, who resigned to accept responsibility for the scandal, former Finance Minister Kiichi Miyazawa, former LDP secretary general Shintaro Abe, former Prime Minister Yasuhiro Nakasone and former chief cabinet secretary Takao Fujinami, who is under indictment for accepting bribes from the employment and information services conglomerate, were among the tainted officials returned to office. Mr. Nakasone, who faced what was described as one of the toughest races of his 16-term career, declared that the elections "purged" himself and others caught in the Recruit web. "The general election is the highest judgment of the people . . . so I think the case has been closed," he said.

Table 4: Lower House Candidates Implicated in Recruit Scandal

Name	Party	Result
Shintaro Abe (former foreign minister)	LDP	X
Takao Fujinami (former chief cabinet secretary)	Independent	X
Takujiro Hamada	LDP	X
Bunmei Ibuki	LDP	X
Koichi Kato (former defense minister)	LDP	X
Mutsuki Kato	LDP	X
Kiichi Miyazawa (former finance minister)	LDP	X
Yoshiro Mori (former education minister)	LDP	X
Yasuhiro Nakasone (former prime minister)	Independent	X
Kunio Takaishi (former education ministry official)	LDP	O
Noboru Takeshita (former prime minister)	LDP	X
Keishu Tanaka	DSP	X
Saburo Tsukamoto (former DSP chairman)	DSP	X
Takumi Ueda	JSP	X
Hideo Watanabe	LDP	X
Michio Watanabe (former finance minister)	LDP	X

LDP = Liberal Democratic Party
DSP = Democratic Socialist Party
JSP = Japan Socialist Party

X = won
O = lost

Source: The Japan Times, February 19, 1990

Reining in the ruling party - But the electorate did not completely let the LDP off the hook on tax reform. Sadanori Yamanaka, who, as chairman of the

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[1] Shuei Sai, "Election Reveals Shift in Japan Politics," Asian Wall Street Journal, March 5, 1990.

LDP tax committee, played a key role in developing the controversial 3 percent consumption tax, was voted out of office. Three other ruling party members active in the tax reform debate -- Tatsuo Murayama, former finance minister; Takeshi Noda, vice chairman of the LDP tax committee; and Yuji Tsushima, secretary general of the LDP tax committee -- were returned to the Diet but with considerably less support than they had received in the 1986 elections. An important plank in the JSP's platform is that the consumption tax should be abolished; the other noncommunist opposition parties also oppose the tax. Thus, by voting incumbents involved in tax matters out of office or supporting their reelection with much slimmer margins, the electorate signaled its expectations that the ruling party leadership had better engage in meaningful action on tax reform during the Diet's current extraordinary session.

Losses in some traditional strongholds also sent a warning to the LDP. Much of the JSP's 58-seat gain in the lower house came from rural districts heretofore dominated by the LDP. Most analysts attribute this backlash to farm constituents' continuing anxiety over the ruling party's agricultural reform policies. In Japan's rice belt (northern Tohoku), for example, LDP-held seats fell from 38 to 30, while the JSP picked up an additional six seats, bringing its total in this part of the country to 16. In Niigata prefecture, another major rice-producing area, the JSP gained a seat each in two LDP-dominated districts; the Socialists also successfully clinched a seat each in two Shikoku districts. The defeated LDP incumbents in these areas were not political novices. In Miyazaki's all-LDP second district a Socialist candidate unseated former Agriculture Minister Hisao Horinouchi. In addition to championing unpopular farm policies, Mr. Horinouchi further had damaged his reelection prospects by making sexist remarks last summer concerning JSP leader Takako Doi's leadership abilities (see JEI Report No. 27B, July 14, 1989). Other LDP agriculture experts stripped of their seats included Tatsuo Sasayama in Akita's second district and Tokuichiro Tamazawa in Iwate's first district.

Judging by voters' rejection of these LDP policymakers, a widely held interpretation of the JSP's performance is that the Japanese public feels the ruling party should be reined in a bit more. The JSP alone was able to increase its representation, from 83 seats to 141 seats; the other three major opposition parties all lost seats. Some analysts do not even attach much importance to the JSP's gains, pointing out that in the late 1960s the Socialists held approximately 140 lower house seats. For the next five elections the JSP managed to retain 110 to 120 seats until it suffered a major setback in 1986, winning only 85 seats. Thus, this more recent victory merely was a return to the party's previous strength.[2]

Further putting the JSP gains in context was Yohei Kono, a senior LDP member, who was quoted as saying, "The votes that went to the Socialist Party were checking votes against the LDP." Professor Yukio Suzuki of Yokohama University concurs that the electorate did not want to see the LDP "run ahead alone trying to have its way." Voters wanted the JSP, the largest of the opposition parties, to maintain a close watch on the ruling party and restrain it when necessary, so they concentrated their anti-LDP votes on JSP candidates, Mr. Suzuki maintains.[3]

[2] _Ibid_.

[3] Yukio Suzuki, "Perceptions Must Change," _The Japan Times_, March 6, 1990.

Where the opposition parties fell down - Despite these impressive inroads, the Socialist Party did not perform as well as it had hoped in the lower house contests. In fact, the extent of the ruling party's win surprised even many LDP members who, reflecting on the upper house outcome, were fearing the worst, that is, securing only a simple majority.

Granted, the JSP did not field enough candidates to seriously undermine the LDP's chances of securing at least a simple majority. Opposing the ruling party's slate of 320 candidates were approximately 155 JSP candidates; 131 from the Japan Communist Party; 58 from Komeito; 44 for the Democratic Socialist Party; and six each from the United Social Democratic Party and the Progressive Party. Of the 271 seats needed for a stable majority, 235 LDP candidates were considered "safe" prior to the elections, while 36 others faced tough races.

These 36 races, at least, would appear to have provided the JSP with a good chance of cutting into the ruling party's majority. What happened? The JSP's biggest handicap in trying to convince the Japanese people that it can govern the country better than the LDP is its lack of national leadership experience. Following its upper house success, the Socialist Party could have capitalized on its momentum and instilled confidence among the electorate by coming forward with coherent policy alternatives. Instead, the JSP remained mired in its own internal, ideological cleavages and proved unable to forge a coalition with the other noncommunist opposition parties. This only reinforced the public's impression that the Socialist Party should not be entrusted with major governing responsibility.

While voters, in the end, did see fit to expand the JSP's lower house presence as a check on the ruling party, this was at the expense of the other opposition parties. Komeito dropped to 46 seats from 55, the JCP to 16 from 27, and the DSP to 14 from 26. The JCP's usually stable base of support apparently was shaken by the blows to communism's influence in the Soviet bloc as well as Beijing's oppression last year of the student-led democracy movement. The DSP and Komeito, which occupy the philosophical center of Japan's political spectrum, were hurt by their inability to offer attractive policy alternatives that clearly differentiated them from the ruling party on the right and the JSP on the left. Thus, voters who wanted to cast an anti-LDP vote apparently were more inclined to support the JSP simply because it is the largest opposition party with at least some muscle.

Implications for the Multiparty System

While the lower house elections reaffirmed that the LDP will continue to play a dominant role in governing Japan, the successive gains by the JSP in both upper and lower house contests -- and related losses by the other opposition parties -- raise questions about the future of Japanese politics. There is a view that the poor showing of the DSP and Komeito, in particular, may be symptomatic of a transition toward a two-party system. Such a system would feature two new parties, which -- even though their names might still be the same -- could stand for policies and programs quite different from those endorsed by the current LDP and JSP.[4]

[4] Nathaniel B. Thayer, lecture before the Japan-American Society of Washington, January 31, 1990, Washington, D.C.

Prospects for such an evolution do not envision the opposition parties uniting as one under current circumstances. Although the four major opposition parties convened a special summit last spring ostensibly to lay the foundation for a coalition that could take on the LDP, organizational problems and ideological differences have stood in the way of unity. The JCP refuses to cooperate with any other party. Among the three noncommunist opposition parties the potential for unity exists, but the JSP's left wing persistently has blocked efforts to resolve important differences -- even in its own party -- on defense and foreign policy issues. The JSP, Komeito and DSP share disparate views on Japan's defense role and the U.S.-Japan Mutual Security Treaty, nuclear power construction and recognition of North Korea.

With the Socialists' gains in the lower house contests, the possibility of bridging these differences appears even more remote. Indirectly suggesting that the weakened Komeito and DSP have no choice but to follow the Socialist Party line, JSP secretary general Tsuruo Yamaguchi declared that "the JSP's big gains in the [lower house] election indicate that the voters supported the policies of the JSP. . . . [O]ur bargaining power with the LDP depends on our unity as a majority force in the upper house against the LDP's control of the lower chamber." But the centrist parties have refused to budge. Responding to Mr. Yamaguchi's remark, Yuichi Ichikawa, secretary general of Komeito, stated that while "opposition unity may be beneficial for the JSP, we are not an auxiliary force for [this party]."

Rather than aligning with the Socialists, the DSP and/or Komeito may decide to join the Liberal Democratic fold. On defense and foreign policy matters, in particular, there are virtually no differences between the centrist parties and the LDP. However, it is improbable that the DSP or Komeito would enter into such an alliance without demanding policy concessions from the LDP, possibly in the social welfare area; they also no doubt would want cabinet positions. A more likely scenario would see an issue-by-issue LDP coalition with one or both centrist parties in a bid to facilitate Diet action.

Unexpected, impressive gains in the upper house elections by Rengo, the political arm of the Japanese Private Sector Trade Confederation, put that group forward as a possible "adhesive" that could hold the noncommunist opposition together (see JEI Report No. 32A, August 18, 1989). Rengo enjoys the support of all four main opposition parties and has stated outright that it views itself as an opposition party coordinator rather than as an ideological entity. While the fledgling party may yet realize its aspirations, its poor showing February 18 (of the five candidates it backed, only one was elected) has raised doubts. Yet, some political observers remain optimistic that in the longer term Rengo may help right-wing members of the JSP, DSP and Komeito form a new, reformist political entity.[5]

The JSP appears to have the potential to develop into a party capable of governing the country -- if it can find an ideological common ground that would unite its extremist elements. Unlike the LDP, which draws its backing primarily from the business community and the agricultural sector, the Socialists have demonstrated in the past two elections that they can gather support from numerous segments of society.

[5] Sai, op. cit.

Yet, to date, the JSP has relied on reactive policies rather than promoting new ideas that can serve as national policies. On the consumption tax, for example, the Socialists have been adamant that the tax be abolished or completely overhauled. Passage of such legislation by the upper house, however, was not accompanied by concrete, fiscally responsible substitute tax measures. Instead, the Socialists said such measures would be forthcoming after lower house action to abolish the tax. This strategy was not well conceived. Although the upper house measure was sure to meet defeat in the lower house, the JSP lost its opportunity to work toward a compromise. The LDP's proposed revisions are sure to retain the 3 percent tax in some form. Had the JSP chosen to cooperate with the ruling party rather than taking a rigid stand, it might have realized even greater reductions or exemptions to the tax.

Its position on defense also is not in tune with international developments and Japan's emergence as a global power. The JSP traditionally has favored a neutral defense posture for Japan and opposed the U.S.-Japan security treaty. Although the Socialists have begun to soften their rhetoric on defense, acknowledging that Japan is "a member of the Western camp," for example, the left wing of the party continues to seriously constrain the JSP on this issue. This ideological rigidity also makes it difficult for the party to attract leadership talent comparable to Ms. Doi's caliber.

The reshaping of Japan's political landscape may be left to the voters themselves. Professor Nathaniel B. Thayer of the John Hopkins University School of Advanced International Studies notes a newfound fluidity in the voting pool as the Japanese electorate seems to be responding more individualistically and, thus, be more willing to change alliances and loyalties.[6] Commitment to the group, whether it is a company or a political party, is not as strong as it once was, Mr. Thayer suggests. Until recently Komeito had the most stable core of supporters, followed by the JCP and the DSP. The recent elections indicate these cores are disintegrating. Estimating that core party advocates in Japan will take about two or three elections to completely change their party loyalties, Mr. Thayer foresees considerable instability in voter behavior in the near future. That instability, in turn, will drive the political reform process. The nature and the direction of systemic change most likely will be apparent after the 1992 upper house elections and the next lower house contests, to be held in 1994 at the latest.

Prospects for the LDP

Not only does Japan's political system appear to be entering a period of transition, but the ruling party itself may be on the verge of a shake-up. Developments surrounding Prime Minister Toshiki Kaifu's election last August and his recent reelection to the top leadership post point to important undercurrents of change in the LDP. Specifically, there appears to be a generational struggle between the LDP old guard, whose chieftains owe their power to the party's traditional factional organization, and younger members, who believe the party needs new leadership with fresh ideas and are impatient about waiting their turn.

The roots for the clash between old and new lie in the LDP's factional system. The factions function as conduits for campaign funds and power bases for prospective prime ministers; they have grown large in size and, not surprisingly, become more institutionalized. Moreover, while the personal tie between a faction leader and a member was an important characteristic of these groups during the early days of the ruling party, these relationships have weakened as a pyramid-like hierarchy has evolved to manage the faction's activities. This, in turn, makes the faction more susceptible to splintering.[7]

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[6] Thayer, op. cit.

Ironically, the very lack of personal bonds in a large faction also can make it difficult for members to agree on how a breakup should proceed and who will lead the new groups. In addition, the size of a faction is important for determining the premiership. Thus, until recently it seemed that as long as faction size had a crucial bearing on who governed the country, a splintering of these groups was unlikely to occur.[8]

But a new breed of LDP politician has emerged that feels stifled by the old order. Members such as Finance Minister Ryutaro Hashimoto, LDP secretary general Ichiro Ozawa and Tsutomu Hata -- all under 60 years of age and members of the faction headed by Mr. Takeshita -- have risen rapidly through the ranks and are thought to have enough support to break away and form their own groups.[9] As faction leaders they then would have a shot at the premiership. Whether or not this happens will depend in the short run on the nature and duration of Mr. Kaifu's tenure as prime minister.

The elevation last summer of the former education minister, a member of a small faction headed by Toshio Komoto, to the top leadership position indicated that party leaders had abandoned a cardinal rule of the factional system -- that is, that only faction leaders are eligible to become prime minister. In the wake of the LDP's upper house debacle and the scandals that forced the successive resignations of Mr. Takeshita and ex-Prime Minister Sosuke Uno, ruling party elders felt that Mr. Kaifu, who was untainted by the Recruit affair, projected a "clean" image that would restore the electorate's confidence in the LDP. At 59 years of age he also projected a comparatively youthful image.

Since Mr. Kaifu was not a faction leader, he was regarded by party doyens as a stopgap leader who would serve until the LDP recouped its losses. Former secretary general Abe or ex-Finance Minister Miyazawa, who both lead major factions, then could seize the reins since enough time would have passed to absolve them of their Recruit-related "sins," senior party officials assumed.

Mr. Abe's designs on the top position became apparent in January as the parties began gearing up for the lower house elections. The former LDP secretary general, who also has served as foreign minister, headed a diplomatic mission to Moscow for discussions with Soviet party leader Mikhail Gorbachev about the longstanding stalemate concerning Soviet occupation of the islands north of Hokkaido (the Northern Territories) claimed by Japan (see JEI Report No. 4B,

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[7] Tomohito Shinoda, "LDP Factions: Their Power and Culture," Bulletin (The Japan-American Society of Washington, Washington, D.C.), XXV, No. 2, February 1990.

[8] Thayer, op. cit.

[9] Thayer, ibid.

January 26, 1990). Ordinarily, such high-level discussions would have been undertaken by the prime minister. This led to speculation that Mr. Abe's foray was intended to establish himself as a leading contender for the premiership if or when Mr. Kaifu stepped down, either at the end of his two-year term or if the LDP took a beating in the February 18 contests. There also were reports that although the prime minister expressed an interest in incorporating the Moscow meetings into his mid-January European tour, LDP leaders discouraged this approach so that Mr. Abe instead could enjoy a bit of diplomatic limelight (as well as divert some attention from Mr. Kaifu's tour).

Mr. Kaifu's lack of a power base also was apparent when the ruling party dissolved the lower house without hearing the prime minister's traditional policy address (see JEI Report No. 5B, February 2, 1990). The prime minister reportedly had wanted to deliver the speech so that he could highlight the positive outcome of his recent European initiative (see JEI Report No. 3B, January 19, 1990). Ruling party strategists apparently persuaded him to forgo this tradition as a means of denying the opposition parties an opportunity to preview their anti-LDP stump speeches. However, this unprecedented decision served to reinforce the impression that Mr. Kaifu was not "his own man" but simply a puppet of Mr. Takeshita's powerful faction.

The extent of the ruling party's February victory virtually blocked any LDP leaders' hopes of calling for the "stopgap" leader's resignation. Mr. Kaifu therefore won reelection February 27 soon after the Diet was convened for a 120-day extraordinary session. However, this does not mean that the ruling party has abandoned its "faction-leaders-only" criteria for selecting the prime minister. The ensuing protracted nature of Mr. Kaifu's cabinet selections suggests that the raison d'etre ~~for~~ factions -- power-brokering -- is deeply rooted. Mr. Kaifu, although reelected, still can expect to face some tough challenges from senior LDP officials who long have coveted the top slot.

Determination of the new cabinet followed the customary resignation en masse of Mr. Kaifu's first cabinet. Although the prime minister officially names his cabinet, in practice he makes the appointments after deliberations with the major faction leaders to ensure that each group is represented in the cabinet according to its relative strength within the party (see Table 5). Discussions apparently became heated after the prime minister, who declared that political reform would continue to be one of the top priorities of his new administration, was adamant that his cabinet members be politically "clean." This eliminated from contention several ruling party members favored by their respective faction leaders.

Mr. Kaifu locked horns with Mr. Abe and Michio Watanabe, a former finance minister who recently took over control of the fourth-largest LDP faction from ex-Prime Minister Nakasone. Both faction leaders wanted appointments for their proteges. However, Mr. Watanabe's candidate, Takayuki Sato, had received a suspended sentence for his involvement in the 1976 Lockheed Corp. bribery scandal. Mr. Abe's choice, Yoshiro Mori, was one of the top LDP recipients of stock shares from Recruit. The prime minister stood firm in rejecting both candidates. Mr. Mori withdrew, but not until after marathon discussions did the Sato nomination fall, when Mr. Kaifu, in an apparent compromise, appointed Kabun Muto, an "untainted" member of the Watanabe group, to the post of international trade and industry minister (see JEI Report No. 10B, March 9, 1990).

Mr. Kaifu's adherence to principle over politics received positive press play and no doubt improved his image with voters concerned about the LDP's

Table 5: Liberal Democratic Party Factions

(as of February 20, 1990)

Faction Leader	Number of Members
Noboru Takeshita*	69
Kiichi Miyazawa	58
Shintaro Abe	58
Michio Watanabe**	46
Toshio Komoto	26
Susumu Nikaido	4
Independents	14

*To accept responsiblity for the involvement of some Liberal Democratic Party members in the Recruit Co., Ltd. bribery scandal, Noboru Takeshita resigned April 25, 1989 as prime minister and LDP president. At this time he also stepped down as head of his faction. Shin Kanemaru now leads the Takeshita faction.

**Michio Watanabe earlier this year assumed control of the faction formerly headed by ex-Prime Minister Yasuhiro Nakasone. Mr. Nakasone stepped down last spring as leader of this group and withdrew from the LDP due to his association with Recruit Co., Ltd.

Source: The Japan Times, February 20, 1990

backroom politics. However, Japanese observers emphasize that the clashes with Messrs. Watanabe and Abe further underscored the prime minister's weak power base and, in turn, could affect his ability to unify the LDP on particularly contentious domestic and international policy matters that the Diet is expected to consider this year. As mentioned, the prime minister has committed himself to reforming Japan's political system. However, a critical -- if not immediate -- element of this entails abolishing the multiseat system, in which Japan's 130 electoral constituencies each are given three to five seats in the lower house. Since many members of both the ruling and the opposition parties stand to lose in moving to a U.S.-style single-seat system, this no doubt will be a very divisive issue.

Other contentious domestic issues the prime minister will have to negotiate include tax reform and land reform, among others. On the international front Mr. Kaifu has committed himself to breaking the deadlock in the Structural Impediments Initiative talks. Some of the issues Washington wants Tokyo to address under SII, such as opening up Japan's distribution system, also affect powerful LDP constituencies. Analysts suggest that Mr. Kaifu simply does not possess the raw power or leadership acumen to tackle such an ambitious agenda and successfully shape a consensus for change.

This may be precisely what Mr. Abe and others would like to see happen. There is a view that party elders may use a "crisis" in U.S.-Japan relations, perhaps precipitated by a lack of progress under the SII talks, to pressure the prime minister into resigning before his term is up. This finally would allow faction leaders to reinstitute the seniority-based system.

But Mr. Kaifu's departure also would create opportunities for the new generation of LDP members to grab at the brass ring. In fact, Mr. Thayer of SAIS predicts that the next race for prime minister may precipitate a splintering of the Takeshita faction, with Messrs. Hashimoto, Ozawa, Hata and possibly others splitting off to form their own groups. Such a development would not destabilize LDP politics so much as it would create new discipline in the factions since they would be smaller, and, thus, three or four factions no longer would dominate party politics.[10]

The prime minister yet may survive his upcoming trials and go on to win another reelection bid, which would reflect an important break from the traditional factional system. At present, however, there is strong support among ruling party members -- both the old-timers as well as the new breed -- for factions as an organizational means of grooming Japanese government leaders. This means Mr. Kaifu no doubt will continue to face rough sailing.

Policy Implications

Ruling party members are relieved to have cleared the hurdle posed by the lower house elections, an accomplishment, they maintain, that reaffirms their opinion that the LDP is the most qualified party to rule Japan. But the LDP is not home free. The opposition parties still dominate the House of Councillors, which could pose problems for the ruling party in enacting nonbudget legislation. As a means of reining in the ruling party, the political opposition may use its upper house majority to reject lower house-passed initiatives and/or pass its own alternatives. While the LDP enjoys a stable majority in the lower house, its 286 votes are well below the two-thirds majority, or 341, needed to override an upper house action. A legislative deadlock could result unless the LDP secures the cooperation of a good portion of the political opposition.

Even before the February 18 contests senior ruling party members floated the idea of a LDP-opposition coalition. Mr. Takeshita, in fact, proposed December 14 that the LDP consider forming a "partial coalition" with some of the opposition parties. Although not explicitly mentioning Komeito or the DSP, he implied that the two centrist opposition parties would be logical candidates. Shin Kanemaru, former deputy prime minister and head of the Takeshita faction, came forward December 26 with an even bolder approach: formation of a "broad coalition government centering on the Liberal Democrats and the right wing of the JSP" (see JEI Report No. 2B, January 12, 1990). The JSP categorically has rejected any coalition with the LDP. Reacting to Mr. Kanemaru's statement, Makato Tanabe, a leader of the JSP's conservative wing, declared, "There is no way that we are going to become a supplementary force" to the LDP. Following the elections JSP secretary general Yamaguchi stressed that the political opposition has more bargaining power if it remains united.

The DSP and Komeito also have resisted a coalition, although given the losses they suffered in the lower house contests and the JSP's rigidity, a formal alignment with the ruling party might appear more attractive at this stage. In any event both parties definitely have left the door open to a "policy-by-policy" partnership with the LDP-led government. A senior Komeito member. Akira Kuroyanagi, suggested that his party might cooperate with the LDP on foreign policy issues. The DSP has indicated possible cooperation with the ruling party on tax reform. This is a switch for the DSP, which went along with the JSP when the upper house passed legislation last December abolishing the consumption tax. The LDP's plan would eliminate the tax on food at the retail stage and reduce it to 1.5 percent at the farm and wholesale levels.

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[10] Thayer, ibid.

As mentioned, a coalition with the LDP actually might prove more beneficial to the DSP and Komeito since the ruling party presumably would be forced to accommodate at least some of their views. This could have important implications for the host of contentious issues Mr. Kaifu's administration must deal with this year. Since these centrist groups tend to draw more of their support from urban and semirural areas, for example, they might favor land reform measures that exceed what the ruling party is willing to support given its traditional rural constituency. In addition, neither the DSP nor Komeito is likely to be an enthusiastic ally on political reform since they would have the most to lose in changing the multiseat system; thus, either would be in a position to block such a reform.

The exigencies of Japanese politics also may exacerbate the already tense atmosphere in U.S.-Japan relations. Lack of cohesion may make it much tougher for the ruling party to support market-opening regulatory or administrative changes. Given their historic ties to trade unions, for example, the Democratic Socialists may not wholly embrace some of the liberalization measures the LDP-led government has said it wants to pursue under the SII, such as more flexible implementation of the Large Retail Store Law. Moreover, none of the opposition parties has ever championed reform of the agricultural sector, which no doubt would compound the ruling party's problems in trying to open Japan's rice market to even limited foreign competition.

Conclusion

The February 18 lower house elections marked an important, but not a dramatic, shift in Japanese politics. In one analyst's words, voters wanted to "shake things up without tearing them apart."[11] The 1992 upper house contests should give a clearer indication as to whether the multiparty system is evolving toward the U.S. model. The next House of Representatives elections, probably in 1994 but possibly sooner if Mr. Kaifu or his successor decides to dissolve the lower house, will provide further evidence.

The LDP also appears headed for change due, in part, to the restlessness and ambition of its younger members. However, the nature and timing of any internal reorganization appears to hinge on how well Mr. Kaifu can lead his party and the country in the near future. The developments of the past year have made it virtually impossible for the ruling party to revert to its old ways.

[11] Sai, op. cit.

For further information, contact Barbara Wanner.

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The views expressed in this report are those of the author and do not necessarily represent those of the Japan Economic Institute.

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IN THIS ISSUE:

Fiscal Process Frozen 1

New Medium-Term Fiscal Plan Unveiled 3

Japanese Firms Plan Higher Investment In FY 1990 4

Shipping Companies Escape Shoals 7

APEC Agrees On Economic Work Program 9

Takeshita Continues Trade Diplomacy 10

Tokyo Drafting SII Package 11

Notes: Indonesian Telecommunications Project .. 13

Fiscal Process Frozen

Although the ruling Liberal Democratic Party coasted to victory in recent lower house elections, determined opposition parties have continued trench warfare to frustrate government efforts to obtain legislative approval of vital spending bills. With the end of the fiscal year (March 31) fast approaching and prospects dim for a compromise between the LDP and the opposition on important fiscal issues, Diet approval of the FY 1989 supplemental budget is certain to go down to the wire. Work on the spending plan for the new fiscal year accordingly will be delayed. This fiscal freeze is unlikely to harm the nation's economy but may have an adverse impact on Japan's external relations.

The Y5.9 trillion ($39.3 billion at Y150=$1.00) supplemental authorization contains money for disaster relief programs, government salary increases and public works projects, to name a few (see JEI Report No. 1B, January 5, 1990). The LDP originally had hoped to pass the supplemental FY 1989 spending

While the 5 percent ceiling on bond issues has no economic rationale, MOF's real intention is to finance part of public works spending by general tax revenues rather than construction bonds. The proposed FY 1990 budget for public works is around Y6.2 trillion ($41 billion), of which 91.6 percent is expected to be financed through new construction bond issues. If the Council on Fiscal Policy's target is achieved in FY 1995, however, construction bonds will cover only 53.9 percent of public works expenditures, which also are projected to increase 4.75 percent a year and reach nearly $7.8 trillion ($51.7 billion) that year. Obviously, if the economy stumbles and tax revenues decline significantly, the government will have to issue more construction bonds. But MOF believes the government will be able to avoid a return to deficit financing by expanding issues of construction bonds in periods of slow growth.

MOF's new fiscal goal is certain to cause a confrontation with Washington, which has asked Tokyo in the Structural Impediments Initiative talks to increase spending on infrastructure (see article in this issue). The Bush administration wants the government to raise the ratio of public investment to gross national product to 10 percent within five years. For FY 1990 that figure is estimated at 6.6 percent.

To illustrate what it would take to reach the 10 percent ratio, Nihon Keizai Shimbun recently calculated that in FY 1988 public works spending would have had to increase by Y4.1 trillion ($27.3 billion). Actual public works spending that year was up Y1.2 trillion ($8 billion), but only because the government earmarked that amount from the proceeds of its sale of Nippon Telegraph and Telephone Corp. shares. This implies that an additional Y6 to Y7 trillion ($40 to $46.7 billion) would be needed in FY 1995 to meet the U.S. request. This is a nearly impossible task given the government's intention to reduce new issues of construction bonds and the unlikelihood that a big tax increase would be enacted to achieve that end.

In addition to the five-year fiscal goal, the Council on Fiscal Policy's March 1 report included the following recommendations:

- Deficit-financing bonds should be redeemed as early as possible to cut interest payments and the total outstanding debt, which is expected to reach Y164 trillion ($1.1 trillion) by the end of FY 1990. This suggests that bond redemption be front-loaded despite the official 60-year redemption period.

- Transparency should be implemented in the budget process as soon as possible to eliminate smoke-and-mirror measures, which were introduced to make the government deficit look smaller in the early 1980s.

- The government should keep increases in total expenditures equal to or less than the nominal GNP growth rate.

Hideo Takahashi

Japanese Firms Plan Higher Investment In FY 1990

On the eve of Japan's new fiscal year, which begins April 1, Japanese firms are planning to spend more on new plant and equipment than they did during FY 1989, when investment hit record levels. That is what a number of government and private surveys of corporate investment plans indicate, as summarized in Table 1. Surveys limited to the largest Japanese firms show a spending increase of almost 9 percent in nominal terms; more comprehensive investigations that include small and midsized firms point to a smaller, but still substantial, boost.

Table 1: Surveys of Plant and Equipment Spending

	Most recent survey	Number of firms	FY 1987 (actual)	FY 1988 (actual)	FY 1989 (estimated)	FY 1990 (forecast)
Nihon Keizai Shimbun	2/90	1,484	1.1%	14.5%	16.3%	8.7%
Japan Development Bank	2/90	1,958	4.4	18.8	17.4	8.6
Economic Planning Agency	12/89	4,475	10.6	26.7	21.0	n.a.
Nominal Plant and Equipment Spending*	--	--	7.5	16.8	14.3	7.6

*Gross national product basis. The FY 1989 and the FY 1990 figures are based on the government's economic outlook for FY 1990, which was announced in December 1989.

In past years such early predictions have proven to be extremely conservative. For example, in February 1989 the firms surveyed by the Japan Development Bank expected to increase spending 6.8 percent in FY 1989; resurveyed last month, they said the boost would come to 17.4 percent. Similarly, the initial FY 1989 survey by the Nihon Keizai Shimbun, the economic daily, showed an expected 6.8 percent gain, but now firms are anticipating a 16.3 percent increase.

Washington views the current FY 1989 figures with some alarm, suggesting that the higher investment spending levels could lead to an export boom. American policymakers presumably are most interested in the manufacturing sector, which has shown slightly higher capital spending increases than nonmanufacturing (see Table 2). Some prominent Japanese exporters, such as automotive manufacturers, have hiked spending during FY 1989 and are almost as upbeat about the coming fiscal year. Their FY 1990 projections, especially if they prove as conservative as they have in the recent past, would appear to make the prospect of an export surge even more likely in Washington's view.

Tokyo has responded that increased plant and equipment spending is not directed toward additional capacity. Of course, insofar as modern plant and equipment replace dated facilities or research and development expand as a result of higher spending, the competitiveness of Japanese firms in the international market grows. In such a situation the Japanese economy absorbs more savings in the short run to finance the new plant and equipment, which implies smaller capital outflows, other factors being equal, and smaller current account surpluses. Over the course of several years, however, a larger Japanese

Table 2: Plant and Equipment Spending by Industry, FY 1989 and FY 1990

(percent change compared to previous year)

	FY 1989 (estimated)	FY 1990 (projected)	FY 1990 Share of Total Plant and Equipment Spending
All Manufacturing Firms	26.6%	10.5%	50.4%
Food	15.9	3.1	3.4
Textiles	8.7	5.8	1.9
Paper and Pulp	18.5	6.0	2.0
Chemicals	26.8	10.0	4.9
Pharmaceuticals	28.8	13.6	1.1
Petroleum	25.9	28.2	1.3
Rubber	33.7	14.1	0.7
Glass and Stone	22.0	22.5	1.8
Steel	39.6	8.8	4.3
Nonferrous Metals	40.8	13.2	2.4
Nonelectric Machinery	34.8	18.2	3.0
Electric Machinery	27.9	7.1	11.9
Ships	-0.5	7.7	0.7
Motor Vehicles	27.2	14.7	8.2
Other Transport Equipment	72.6	28.9	0.2
Precision Instruments	22.9	11.4	1.1
Other Manufacturing	26.2	5.6	1.5
All Nonmanufacturing Firms	7.7	7.0	49.6
Fisheries	48.6	-24.4	0.0+
Mining	15.4	47.0	0.2
Construction	21.5	25.3	2.8
Trading Companies	6.4	-3.8	1.4
Retailing	17.7	16.8	3.6
Other Financial Companies	-49.7	42.6	0.0+
Real Estate	25.5	16.0	2.3
Railroads and Buses	19.3	1.0	4.4
Other Land Transportation	25.0	10.1	0.4
Sea Transportation	36.6	-40.4	0.2
Air Transportation	27.2	31.5	2.4
Warehousing	23.1	37.1	0.5
Communications	0.0	0.6	9.1
Electric Power	1.5	6.2	19.6
Gas	10.8	-7.5	1.4
Services	18.9	10.8	1.3
Total	16.3	8.7	100.0

Source: Nihon Keizai Shimbun

economy would result from the boost in capital spending, with imports and exports both higher than otherwise and uncertain consequences for the current account.

Of course, beleaguered U.S. companies are not likely to welcome the news that Japanese exports could be headed higher. Such firms may take some consolation from the prospect that investment levels could end up substantially lower than currently expected. The most recent of the surveys summarized in Table 1 were taken after interest rates rose late last year and the Tokyo stock market began declining in January; they do not, however, reflect the continuation of these trends into late March. Should financial markets remain weak, firms counting on raising money from selling equity or borrowing to finance their spending plans could have difficulty meeting their objectives.

In addition, a growing number of Japan's corporate leaders see the prospects for the balance of 1990 as unfavorable. For example, a poll taken in early March by Asahi Shimbun, one of the country's largest dailies, found a bare majority of the 100 top corporate executives in Japan expecting an economic downturn by the end of the year. In the same survey 67 percent said that the economic expansion is continuing, down from 95 percent in the previous poll taken a year earlier. Should higher interest rates come to be paired with a projected overall slowdown, investment plans could be scaled back dramatically. With plant and equipment spending equaling almost 20 percent of the Japanese economy, the effect on economic growth would be significant.

Douglas Ostrom

Shipping Companies Escape Shoals

Although initials such as NYK, "K" Line and Mitsui OSK long have been fixtures on the American waterfront, another set of familiar maritime initials -- SOS -- often has better described Japanese shipping companies in recent years. In fiscal 1986, which ended March 31, 1987, and again in FY 1987 the companies lost hundreds of millions of dollars on their international business. However, more recently the largest firms, at least, have returned to profitability. The four largest shipping companies recorded profits of Y19.7 billion in FY 1988 ($130 million at Y150=$1.00) and are expected to earn Y33.5 billion ($223.3 million) in the year through March.

As they have struggled to overcome problems, shipping companies unwittingly have highlighted structural issues potentially facing many Japanese industries. One response to their difficulties, for example, has been merger and/or retrenchment. In 1988 Japan Line Ltd. and Yamashita-Shinnihon Steamship Co., Ltd. formed a new company, Nippon Liner System Ltd., to operate the two firms' North American liner freight services. Then last June the two shippers combined all of their operations to form Navix Line, Ltd., the fourth-largest company after Nippon Yusen K.K., Mitsui OSK Lines, Ltd. and Kawasaki Kisen Kaisha, Ltd. In addition, Showa Line, Ltd., another of the traditional big six Japanese shippers, abandoned its North American liner service in early 1988. Even NYK and Mitsui OSK, the industry's leaders, have been forced into some joint projects.

As has happened in other industries facing restructuring, keiretsu and other corporate groups have played a major role in the reorganization of the

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JEI

REPORT

A Two-Part Report: A and B

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IN THIS ISSUE:

BOJ Raises Discount Rate For Fourth Time In A Year 1

Fallout From TSE Fall 3

Japanese Economy At Cruising Speed In 1989 6

Senate Panel Examines Decline In Defense Industrial Base 9

House Hears Administration Views On Exon-Florio 11

Foreign Companies To Face Stronger Tax Law Enforcement 12

Notes: Japanese Budget 14

BOJ Raises Discount Rate For Fourth Time In A Year

In mid-March the Bank of Japan found itself in a familiar, although uncomfortable, position concerning a boost in the official discount rate. On one side was a rock in the form of the Finance Ministry, which felt that another increase in the key interest rate could damage the Japanese economy. On the other was a hard place formed by market-based interest rates that had risen considerably since the previous boost in the discount rate on Christmas Day last year. Raising the discount rate presumably would run counter to the wishes of the Finance Ministry, from which BOJ seldom exercises independent judgment. Keeping the discount rate at 4.25 percent would run arguably an even greater risk: increasing irrelevance to borrowers and lenders in the turmoil surrounding Japanese financial markets.

On March 20 -- after prolonged, sometimes public, coordination with the Finance Ministry -- BOJ took the plunge, raising the key interest rate a full fixed percentage of the present market value of these latent stock assets in their equity calculations. Since lower stock prices translate into less equity Japanese banks will have more difficulty in meeting the new minimum requirements.

For foreign investors and markets the impact will be mixed. The TSE's fall may attract foreign stock investors. The usual yardsticks used by American brokers show Japanese share prices as extremely overvalued. The TSE's decline does not make Japanese stocks a bargain but does make them more reasonable. Foreign stock markets probably will benefit from the TSE's fall since it makes them relatively more attractive to Japanese investors. The relative stability of U.S. markets always has acted as a magnet to foreign investors; this perception is magnified as the TSE continues to gyrate. Conversely, a continued fall of the TSE may force Japanese investors to sell foreign assets to cover losses at home, putting downward pressure on overseas markets, although the strong cash positions of Japanese investors may limit this possibility.

Government and private Japanese criticism of computer-directed index arbitrage trading programs employed by foreign brokers recently has become muted. As the TSE tumbled in late February and early March, Japanese observers charged that such program trading accentuated the downward movement. American brokers vigorously defended their strategies by pointing out that this particular type of program trading accounted for a tiny share of the TSE's daily trading volume. In recent days market watchers have attributed a significant share of buying activity to program trading but Japanese skepticism about it persists.

For all the bad news the Japanese market retains its underlying strength. Panic selling has not gripped the market, as shown by the relatively low daily trading volumes. The dearth of buying sentiment for blue-chip stocks has propelled the major market indices downward. Buyer interest in second-section stocks and in shares sold over the counter has remained strong as the Nikkei has plunged, although the second-section did not escape the impact of Thursday's volatility. Overall, the economic picture still is quite sound. Even though some firms have announced cuts, corporate investment plans show solid growth. Employment remains firm and production high. The political situation also has improved with the Liberal Democratic Party continuing its long run as ruling party with its victory in lower house Diet elections. The March 22 passage of the supplementary budget for FY 1989 by the lower house has relieved immediate worries about fiscal deadlock.

Despite these positive factors, the TSE clearly has entered a new period. Its image of invulnerability has been shattered; Japan's susceptibility to foreign influences has been underscored; the government's cohesion has been tested; and the ties between government and industry have been strained. The cumulative impact of Tokyo's program of financial market deregulation and liberalization clearly has given market forces a much larger role and reduced Tokyo's ability to influence events.

Jon Choy

Japanese Economy At Cruising Speed In 1989

Japan's economy had to overcome numerous obstacles in 1989, including an imperial illness and death that reduced consumer demand, a new consumption tax and almost unprecedented political uncertainty. While such events generally had a negative impact on gross national product, over the course of the year their effect was barely apparent. For calendar 1989 as a whole the economy posted a 4.9 percent inflation-adjusted gain over 1988 (see Table). While the growth rate dropped from the 5.7 percent pace set in 1988, it still was near the top among industrial countries' rates and was roughly in line with forecasts made a year ago.

By comparison the U.S. economy grew 3 percent in 1989. Since stories of Japanese economic prowess fill the U.S. news media, few Americans are likely to be surprised to hear that the Japanese economy grew faster last year. However, apparently many Americans have taken this view of Japan a step further, with nearly a majority in one widely cited 1990 poll believing that the Japanese economy is now larger than that of the United States. As with most such beliefs, such a view has a grain of truth. The latest Japanese figures -- converted into dollars at the actual 1989 average exchange rate and placed beside comparable U.S. ones -- show, for example, that plant and equipment spending in Japan in 1989 was 7.3 percent larger than in the United States. However, using the same exchange rate, the U.S. economy remains 85 percent larger than that of Japan. Most experts believe that the use of actual exchange rates -- rather than rates adjusted for relative purchasing power -- exaggerates the relative size of the Japanese economy. Use of the latter rate, if available, probably would show Japan's GNP less than half that of this country.

Because the Japanese economy is so much smaller than America's, plant and equipment spending looms correspondingly larger relative to the rest of GNP than in the United States, where under 10 percent of nominal GNP consists of such spending. In Japan investment spending by private firms accounts for almost 20 percent of GNP, and in 1989 it explained 3.7 percentage points of the overall 4.9 percent growth. In other words, other factors equal, the Japanese economy would have grown an anemic 1.2 percent in 1989 if firms had not increased their plant and equipment spending over 1988's level.

The other pillar of growth in 1989 was private consumer spending, which added 1.9 percentage points to the overall growth rate, a substantial drop from a contribution of 2.9 points a year earlier. The final important factor was external demand which, for the fourth straight year, reduced the economic growth rate; in 1989 it shaved 1 point off GNP growth. In fact, Japan's 1989 current account surplus was largely a result of falling yen-denominated import prices. (The higher yen in recent years implied lower yen prices since international dollar-denominated prices were rising only slowly.) As the table shows, in 1989 Japan registered a payments deficit on a GNP basis using 1980 prices.

In contrast to previous quarters, which had been subject to considerable volatility, the last three months of 1989 mirrored the year as a whole. October-December growth came to 3 percent on an annualized basis, compared to double-digit growth the previous quarter and negative numbers the quarter before that. Private consumer spending remained strong, contributing 0.9 percentage point to the overall 0.7 quarter-to-quarter growth rate and just matching the amount added to overall growth by private plant and equipment spending, which grew an annualized 16.2 percent.

The continuing critical importance of corporate capital spending raises a question of whether Japan's economic expansion is sustainable in light of recent policy changes. The Bank of Japan raised the official discount rate in

Japan's Real Gross National Product at Constant (1980) Prices

(in billions of yen, seasonally adjusted, quarterly totals and rates of growth at annual rates)

	1988	1989	January-March 1989	April-June 1989	July-September 1989	October-December 1989
Gross National Product	Y330,886.9 (5.7%)	Y347,059.9 (4.9%)	Y343,155.4 (7.2%)	Y340,561.8 (-3.0%)	Y350,436.0 (12.1%)	Y353,005.3 (3.0%)
Personal Consumption Spending	183,376.1 (5.1%)	189,809.4 (3.5%)	188,458.9 (5.5%)	186,600.8 (-3.9%)	190,316.3 (8.2%)	193,336.8 (6.5%)
Private Residential Construction	20,725.8 (11.9%)	21,316.9 (2.9%)	21,341.2 (1.9%)	20,855.0 (-8.8%)	21,328.5 (9.4%)	21,764.2 (8.4%)
Private Fixed Nonresidential Investment	69,343.5 (15.5%)	81,675.1 (17.8%)	77,820.6 (28.3%)	78,320.0 (2.6%)	83,374.1 (28.4%)	86,568.0 (16.2%)
Change in Business Inventories	2,314.3 (77.0%)	1,965.3 (-15.1%)	1,080.4 (*)	2,463.2 (*)	2,077.4 (*)	2,239.8 (*)
Government Current Expenditures	29,151.7 (2.2%)	29,759.4 (2.1%)	29,647.9 (2.6%)	29,650.4 (0.0%)	29,732.0 (1.1%)	30,013.1 (3.8%)
Government Fixed Investment	24,840.9 (5.6%)	24,493.8 (-1.4%)	24,674.3 (2.2%)	24,540.4 (-2.2%)	24,205.1 (-5.4%)	24,497.6 (4.9%)
Change in Government Inventories	-181.6 (*)	-62.5 (*)	261.2 (*)	371.8 (*)	63.4 (*)	-949.1 (*)
Net External Sector	1,316.2 (-79.9%)	-1,897.5 (-244.2%)	-129.0 (*)	-2,239.8 (*)	-660.8 (*)	-4,465.1 (*)
Exports of Goods and Services and Factor Income Received	59,118.6 (8.6%)	68,250.4 (15.4%)	66,337.7 (30.3%)	65,824.7 (-3.1%)	70,171.1 (29.1%)	70,863.4 (4.0%)
Imports of Goods and Services and Factor Income Paid	57,802.4 (20.7%)	70,147.9 (21.4%)	66,466.7 (44.1%)	68,064.5 (10.0%)	70,831.9 (17.3%)	75,328.5 (27.9%)

*Cannot be calculated or meaningless.

Source: Economic Planning Agency

late December and again this month (see article in this issue), suggesting the possibility that plant and equipment spending, usually highly interest sensitive despite the availability of internal funds for investment purposes, may not prove as buoyant in the future as it has in the recent past. Most industry and government officials remain optimistic concerning firms' spending plans, even though a handful of companies announced a slowdown in their investment spending in the wake of the late winter turmoil in the financial markets.

Yutaka Kosai, president of the Japan Economic Research Center, believes that the economy got through the quarter ending March 31 largely unaffected, but he is less confident about the future concerning investment spending. In addition, he and others worry that net exports may pick up should the yen remain weak. Plant and equipment spending may provide less of a boost -- and the external sector less of a drag -- than was the case in 1989. In short, the view through the rearview mirror represented by the most recent GNP figures is likely to look pretty much the same three months from now, but it could differ dramatically after that. Policymakers, who have a mandate to keep their eyes focused on the road ahead, find the landscape already is beginning to change.

Douglas Ostrom

Senate Panel Examines Decline In Defense Industrial Base

Although specific U.S.-Japan trade disputes continue to act as a lightning rod for congressional frustrations about lagging U.S. competitiveness, legislators also have begun to examine more closely some of the factors affecting the overall health of this nation's technologial and industrial base. Building on last year's oversight hearings, the Senate Banking Committee continued March 22 to hear testimony on legislation that would reauthorize the Defense Production Act of 1950, due to expire this summer. This law provides authority for preserving and enhancing the U.S. defense industrial base as well as mobilizing the nation's productive capacity during periods of national emergency.

The impact of the reauthorization process on bilateral economic relations could be significant. The increasing tendency on Capitol Hill and in certain administration quarters to link trade problems with defense needs means that a revised DPA could have as restrictive an impact on U.S.-Japan trade as specific trade sanctions. Some members of Congress have grown increasingly concerned that American high-technology and other defense-related industries are no longer able to cover the nation's security requirements autonomously. They have reacted by proposing anti-Japan, "Buy American"-type solutions (see JEI Report No. 24A, June 24, 1988).

But key representatives of American defense-related industries made no specific mention of shutting Japanese companies out of the U.S. military procurement process during recent comments to the Senate banking panel on S 1379, a bill to reauthorize and amend the DPA. Officials from aerospace and machine tool companies for the most part emphasized the need for greater government-industry cooperation in developing new technologies. The witnesses also called for antitrust exemptions to allow intraindustry cooperation in breaking new technological ground as well as various tax and other incentives that would encourage firms to invest more in advanced technology.

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JAPAN AND MERGERS: OIL AND WATER?

Summary

Mergers and acquisitions certainly are not new phenomena in the corporate worlds of either America or Japan. The 1980s ushered in a new era in the United States when a fearless attitude toward debt financing spawned megadeals. The profit potential of leveraged buyouts did not escape Japanese financial institutions. Japanese manufacturers also recognized that takeovers offered them a quick way to establish a foreign production base and/or to diversify. At the beginning of the 1990s the Japanese are poised to become major global M&A players. While this may seem a natural development for a country with the world's largest banks, brokerage houses and insurers, it represents a significant shift in viewpoint for the Japanese.

The reasons behind changing Japanese attitudes toward mergers and acquisitions, both at home and abroad, are varied. Nevertheless, companies and investors more and more are incorporating M&A into their strategies in response to changing economic and social conditions. The still nascent shift in Japanese attitudes could evolve in many directions, but some patterns already are visible.

Overview

It is a common American belief that mergers and acquisitions are rare creatures in Japan's business world, particularly if either involves a foreign suitor. Until 1980 Japanese foreign exchange regulations were major obstacles to foreign firms interested in buying an existing Japanese company. Even after legal reforms that year substantially eliminated these barriers, foreign investors ran afoul of traditional business practices that are at least as formidable. A record of failure for foreign takeover attempts in the postwar era spread the perception that mergers and acquisitions are not welcome in Japan.

According to statistics compiled by Japan's Fair Trade Commission, however, not only does domestic M&A activity have a healthy record but it also is rising. From an overall standpoint, the data show that the Japanese M&A market has become roughly comparable to its American counterpart in terms of activity but lags significantly in terms of value (see Tables 1 and 2). In the 1960s and 1970s mergers and acquisitions in Japan were less than half the American count. That changed rapidly in the 1980s as the number of both grew. It is clear, however, that acquisitions occur far less frequently than mergers.

The total value of Japan's M&A market, although it advanced in step with increased activity, still is relatively small compared to the U.S. market. A comparison of the number of large M&A deals in each country points to even more disparity. Deals worth more than $100 million grew rapidly in the United States during the 1980s. While the number of big Japanese deals -- defined as Y50 billion ($333 million at Y150=$1.00) or more -- also expanded during this period, the total remained well below the U.S. level.

Most of the M&A activity in Japan takes place among firms capitalized at less than Y500 million ($3.3 million). Tables 3 and 4 show that companies of this size and smaller accounted for over 90 percent of all mergers and 88 percent of all acquisitions in FY 1988. There is a clear dichotomy in M&A behavior between small and large Japanese firms. Although this same phenomenon also is generally true in the United States, the break is sharper in Japan where large Japanese firms may use their cross-stockholdings (discussed below) as a highly effective defense against unwanted overtures.

An analysis by industry shows several contrasts between the two countries (see Tables 5-7). The different structure of the American and the Japanese oil industries, for example, causes great disparity in the data. Although large firms dominate the business in both countries, the host of small U.S. companies has no equivalent in Japan. In the 1980s the American oil industry underwent a severe shakeout; the Japanese industry was quiet. A shakeout also went on during this period among American financial institutions, a trend not mirrored in Japan. (Tokyo's continuing program of financial reform may lead to changes in the 1990s, however.) In addition, there was considerable activity in the wholesale/retail trade industries of both countries, which was not surprising given the volatile nature of the business. Unfortunately, U.S. statistics bury information about the manufacturing sector within the "Other" category. According to Japanese data, there has been a clear upturn in M&A activity in the manufacturing sector, with firms that make electric and nonelectric machinery as well as chemical manufacturers showing the clearest trend.

Statistics on foreign M&A activity in the United States and Japan (see Tables 8 and 9) lend weight to foreign concerns about the openness of the Japanese M&A market since the data indicate foreign activity is far greater in

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Table 1: U.S. Merger and Acquisition Activity, 1970-87

	1970	1980	1981	1982	1983	1984	1985	1986	1987
Mergers and Acquisitions (number)	5,152	1,889	2,395	2,346	2,533	2,543	3,001	3,336	2,032
Value (billions)	$16.4	$44.3	$82.6	$53.8	$73.1	$122.2	$179.8	$173.1	$163.7
$100 Million-Plus Deals (number)	10	94	113	116	138	200	270	346	301

Source: W.T. Grimm & Co. as cited in Department of Commerce, Statistical Abstract of the United States.

Table 2: Japanese Merger and Acquisition Activity, FY 1970-FY 1988

	FY 1970	FY 1980	FY 1981	FY 1982	FY 1983	FY 1984	FY 1985	FY 1986	FY 1987	FY 1988
Mergers (number)	1,147	961	1,044	1,040	1,020	1,096	1,113	1,147	1,215	1,336
Value (billions)	n.a.	n.a.	Y1,960.3	Y2,884.7	Y1,676.6	Y1,918.4	Y3,120.9	Y4,366.6	Y3,198.8	Y3,349.9
Y50 Billion-Plus Deals (number)	n.a.	n.a.	24	5	33	33	26	40	53	51
Acquisitions (number)	413	680	771	815	702	790	807	936	1,084	1,028
Value (billions)	n.a.	n.a.	Y274.9	Y433.8	Y426.8	Y554.1	Y449.5	Y219.5	Y267.4	Y130.0
Y50 Billion-Plus Deals (number)	n.a.	n.a.	26	42	30	48	53	72	78	66

Note: Y50 billion is approximately $333 million at Y150=$1.00.

Source: Fair Trade Commission

Table 3: Japanese Mergers by Size of Firm, FY 1975-FY 1988

(number of announced mergers; capital in millions of yen)

Fiscal Year	Under Y10	Y10-Y49	Y50-Y99	Y100-Y499	Y500-Y999	Y1,000-Y4,999	Y5,000-Y9,999	Over Y10,000
1975	241	426	109	128	14	24	6	6
1976	211	441	111	119	27	27	1	4
1977	211	446	124	164	29	29	5	3
1978	179	365	113	158	51	26	4	2
1979	177	265	205	153	33	28	3	7
1980	192	433	108	158	37	22	6	5
1981	173	424	162	198	43	36	4	4
1982	177	492	144	140	40	35	4	8
1983	157	432	175	184	24	30	10	8
1984	197	482	177	174	19	34	6	7
1985	203	440	231	162	29	33	7	8
1986	206	472	213	167	37	31	12	9
1987	174	491	203	226	42	51	12	16
1988	182	509	250	286	33	48	18	10

Source: Fair Trade Commission

Table 4: Japanese Acquisitions by Size of Firm, FY 1975-FY 1988

(number of announced acquisitions; capital in millions of yen)

Fiscal Year	Under Y10	Y10-Y49	Y50-Y99	Y100-Y499	Y500-Y999	Y1,000-Y4,999	Y5,000-Y9,999	Over Y10,000
1975	117	158	49	53	9	30	0	13
1976	116	209	73	61	13	24	4	11
1977	123	243	89	104	17	50	6	14
1978	140	222	80	91	16	24	5	17
1979	118	262	74	83	26	30	5	13
1980	114	292	86	93	12	25	13	15
1981	137	350	112	96	23	36	7	10
1982	158	322	109	132	24	38	5	27
1983	133	266	115	115	16	31	10	16
1984	129	304	134	158	6	22	10	27
1985	125	290	129	155	24	51	7	26
1986	168	360	124	158	24	48	10	44
1987	168	422	162	205	17	45	11	54
1988	173	391	145	197	11	52	9	50

Source: Fair Trade Commission

the United States than in Japan. While the number of foreign buyers in the United States has increased since 1981, their number is not far out of line with 1980 and 1981 levels. The number of foreign sellers in the United States shows even less of a pattern. In Japan foreign-initiated bids begin to drift

Table 5: U.S. Mergers and Acquisitions by Industry, 1983-87

Number

Industry	1983	1984	1985	1986	1987
Oil and Gas	111	102	86	58	30
Banking and Finance	331	251	381	415	262
Insurance	67	66	67	94	38
Mining and Minerals	18	12	16	14	8
Food Processing	74	58	82	101	78
Conglomerates	13	18	14	20	6
Transportation	36	36	48	58	34
Broadcasting	60	83	93	123	64
Retail	90	130	136	147	150
Brokerage/Investment Firms	63	86	49	47	32
Other	1,670	1,701	2,029	2,259	1,330
Total	2,533	2,543	3,001	3,336	2,032

Value (millions of dollars)

Industry	1983	1984	1985	1986	1987
Oil and Gas	$12,076	$42,982	$23,160	$3,247	$15,442
Banking and Finance	13,628	5,846	14,037	19,442	16,209
Insurance	2,966	3,006	2,694	5,413	2,484
Mining and Minerals	2,946	347	356	148	676
Food Processing	1,164	7,195	11,838	4,707	3,316
Conglomerates	2,745	6,983	16,302	15,307	6,839
Transportation	5,255	1,252	2,877	6,829	4,956
Broadcasting	3,747	1,918	15,013	8,407	8,729
Retail	1,489	6,673	10,030	13,683	17,039
Brokerage/Investment Firms	1,455	1,460	579	1,710	3,492
Other	25,609	44,662	82,882	94,544	84,504
Total	73,080	122,324	179,768	173,437	163,686

Source: W.T. Grimm & Co. as cited in Department of Commerce, Statistical Abstract of the United States.

lower in 1985, but this is somewhat deceptive since the value of such transactions has grown in recent years. Overseas bids by Japanese firms have shown the strongest growth in both number and value, particularly since 1987.

A Different View of M&A

The statistics clearly show that Japan's M&A market has become as robust as the American one in some ways but is significantly noncomparable in others. Differences stem from each country's laws, economic structures, business practices and social attitudes.

- Legal environment - As mentioned previously, prior to 1980 Japan's Foreign Exchange Control Law served as an effective gate, allowing inward and

Table 6: Japanese Mergers by Industry, FY 1984-FY 1988

Number

Industry	FY 1984	FY 1985	FY 1986	FY 1987	FY 1988
Forestry and Fishing	6	6	9	2	7
Mining	2	3	3	6	3
Construction	89	63	60	61	64
Manufacturing	237	221	243	268	291
Food	22	30	24	22	32
Textiles	29	26	15	23	26
Wood Products	18	10	7	14	8
Paper and Pulp	8	11	8	5	9
Publishing and Printing	14	14	10	14	23
Chemicals, Oil and Coal	31	15	34	36	31
Rubber and Leather	4	4	3	3	4
Nonmetallic Minerals	10	15	18	15	14
Steel	10	4	10	7	7
Nonferrous Metals	9	1	5	6	4
Fabricated Metal Products	10	14	26	22	15
Nonelectric Machinery	29	29	15	32	30
Electric Machinery	21	23	32	35	48
Transportation Equipment	7	7	15	12	15
Precision Equipment	9	11	12	7	6
Other	6	7	9	12	19
Wholesale and Retail Trade	377	408	398	409	460
Real Estate	115	104	120	140	143
Transportation and Communications	58	66	50	69	70
Services	106	130	151	142	167
Finance and Insurance	42	30	34	21	19
Electricity and Gas	0	2	1	0	1
Other	64	80	78	97	111
Total	1,096	1,113	1,147	1,215	1,336

Value (billions of yen)

Industry	FY 1984	FY 1985	FY 1986	FY 1987	FY 1988
Forestry and Fishing	Y2.3	Y4.1	Y7.0	Y1.1	Y4.7
Mining	6.8	0.5	0.2	0.3	40.0
Construction	44.6	61.9	36.4	72.7	44.8
Manufacturing	258.9	625.2	1,156.8	1,108.5	528.8
Food	36.0	102.1	8.5	44.7	59.0
Textiles	19.0	30.6	3.5	106.5	36.5
Wood Products	4.9	5.6	0.5	3.9	6.3
Paper and Pulp	11.0	75.1	22.4	3.1	53.6
Publishing and Printing	4.1	28.9	2.9	21.3	20.7
Chemicals, Oil and Coal	23.3	134.0	434.7	92.1	98.8
Rubber and Leather	2.4	17.2	0.3	2.6	1.2
Nonmetallic Minerals	10.3	9.8	16.6	8.6	13.1
Steel	9.6	14.5	16.7	78.2	12.0
Nonferrous Metals	61.5	0.1	55.1	14.2	39.1

Industry	FY 1984	FY 1985	FY 1986	FY 1987	FY 1988
Fabricated Metal Products	3.9	4.3	21.9	31.4	84.0
Nonelectric Machinery	32.6	51.5	12.7	89.9	21.5
Electric Machinery	19.7	14.9	512.1	346.0	36.7
Transportation Equipment	2.8	1.7	26.9	248.7	16.5
Precision Equipment	13.6	132.9	19.6	9.0	10.2
Other	4.3	2.0	2.3	8.3	19.4
Wholesale and Retail Trade	880.6	1,885.5	541.6	845.2	935.0
Real Estate	183.2	224.0	447.7	496.5	680.3
Transportation and Communications	29.3	100.3	153.1	53.7	148.4
Services	248.2	102.0	135.3	166.3	106.7
Finance and Insurance	245.8	44.5	1,848.5	182.4	377.4
Electricity and Gas	0.0	0.7	0.0*	0.0	0.2
Other	18.7	72.2	40.0	272.1	483.6
Total	1,918.4	3,120.9	4,366.6	3,198.8	3,349.9

*Less than Y0.1 billion.

Source: Fair Trade Commission

Table 7: Japanese Acquisitions by Industry, FY 1984-FY 1988

Number

Industry	FY 1984	FY 1985	FY 1986	FY 1987	FY 1988
Forestry and Fishing	3	0	1	2	2
Mining	1	2	3	1	0
Construction	17	11	19	23	21
Manufacturing	76	68	83	94	99
Food	6	8	10	6	12
Textiles	1	7	1	8	5
Wood Products	8	9	11	1	3
Paper and Pulp	2	3	1	3	2
Publishing and Printing	3	1	2	4	5
Chemicals, Oil and Coal	15	8	17	15	22
Rubber and Leather	2	2	1	1	0
Nonmetallic Minerals	9	6	7	7	5
Steel	3	2	2	5	1
Nonferrous Metals	7	1	0	4	1
Fabricated Metal Products	3	7	4	3	2
Nonelectric Machinery	5	5	10	12	8
Electric Machinery	2	3	11	14	15
Transportation Equipment	4	3	3	5	6
Precision Equipment	0	2	1	3	9
Other	6	1	2	3	3
Wholesale and Retail Trade	135	161	171	179	167
Real Estate	9	4	11	11	8
Transportation and Communications	62	49	51	70	67
Services	22	34	29	38	43

Industry	FY 1984	FY 1985	FY 1986	FY 1987	FY 1988
Finance and Insurance	15	16	32	21	28
Electricity and Gas	1	1	0	2	0
Other	449	461	536	643	593
Total	790	807	936	1,084	1,028

Value (billions of yen)

Industry	FY 1984	FY 1985	FY 1986	FY 1987	FY 1988
Forestry and Fishing	Y1.1	Y0.0	Y0.0*	Y0.0*	Y0.0*
Mining	0.4	7.0	0.1	0.0*	0.0
Construction	1.0	0.5	1.0	3.9	0.1
Manufacturing	332.2	49.3	29.3	52.1	15.1
Food	6.6	2.3	0.2	1.8	1.2
Textiles	1.7	0.8	9.3	1.1	3.0
Wood Products	0.0*	0.3	0.1	0.0	0.0*
Paper and Pulp	2.4	1.2	0.3	0.0	0.0
Publishing and Printing	0.0	0.1	0.0*	8.0	0.1
Chemicals, Oil and Coal	304.1	34.1	7.3	5.1	3.0
Rubber and Leather	0.5	0.0*	0.0	0.4	0.0
Nonmetallic Minerals	4.9	0.4	1.2	0.6	0.2
Steel	1.6	0.0*	0.1	14.6	0.0
Nonferrous Metals	5.6	0.8	0.0	0.5	3.5
Fabricated Metal Products	0.7	1.1	0.0	0.7	0.0*
Nonelectric Machinery	0.1	1.5	1.2	8.0	2.4
Electric Machinery	0.1	5.8	9.5	8.6	1.6
Transportation Equipment	1.2	0.8	0.1	0.5	0.0*
Precision Equipment	0.0	0.0*	0.0	0.1	0.0*
Other	2.7	0.0*	0.0*	2.1	0.0
Wholesale and Retail Trade	75.4	327.8	46.0	37.3	13.2
Real Estate	0.1	4.0	0.3	4.8	0.6
Transportation and Communications	9.8	15.1	3.4	4.5	3.8
Services	7.0	12.9	4.5	29.9	2.9
Finance and Insurance	36.0	11.6	32.7	56.5	7.6
Electricity and Gas	4.3	7.3	0.0	0.1	0.0
Other	86.8	14.1	101.9	78.4	86.6
Total	554.1	449.6	219.5	267.4	129.9

*Less than Y0.1 billion.

Source: Fair Trade Commission

outward direct investment only with the government's permission. From 1950 to the mid-1960s foreign direct investments, whether new investments or takeovers, were approved only after careful scrutiny. When Japan joined the Organization for Economic Cooperation and Development in 1964, Tokyo was forced to weaken its control over the convertibility of the yen. Fearing a wave of foreign takeovers, bureaucrats took a very hard-nosed attitude toward foreign interest in domestic firms, sparingly approving any foreign investment applications. This

Table 8: Japanese Merger and Acquisition Announcements, 1984-89

(number of announced transactions)

	1984	1985	1986	1987	1988	1989
Japanese Purchases of Japanese Firms	140	163	226	219	223	240
Japanese Purchases of Foreign Firms	44	100	204	228	315	404
Foreign Purchases of Japanese Firms	6	26	21	22	19	17
Total	190	289	451	469	557	661

Source: Yamaichi Securities Co., Ltd.

Table 9: Foreign Mergers and Acquisitions in the United States, 1982-87

(number of announced transactions)

	1982	1983	1984	1985	1986	1987
Foreign Sellers	121	146	147	175	180	142
Foreign Buyers	154	125	151	197	264	220

Source: W.T. Grimm & Co. as cited in Department of Commerce, Statistical Abstract of the United States.

rigid stance eased gradually through the 1970s as Tokyo slowly brought its regulations on external financial flows into line with OECD guidelines. But even after 1980, when both inward and outward foreign investment was made free in principle, the lack of transparent procedures and some residual restrictions daunted most foreign investors in Japan. In short, mergers and acquisitions involving foreign suitors have received little official encouragement -- and much discouragement -- during most of Japan's postwar era.

Domestic companies interested in mergers also faced major governmental hurdles. Tokyo made rebuilding the economy the nation's top priority; scarce savings were channeled into the creation and expansion of economic infrastructure and private plant and equipment. All other activities, such as acquisitions and consumer finance, were deprived of capital. Japanese companies interested in M&A could not avoid Tokyo's wishes because domestic financial markets had no structures to accommodate them and were completely under the government's thumb.

- Economic factors - Japan's economic miracle provided a comparatively barren soil for mergers and acquisitions by eliminating major motivations for choosing this path. Strong economic growth lowers the rate of bankruptcy and, therefore, mergers, which often are used to stave off bankruptcy. Strong economic growth also provides ample opportunities for expansion, making growth by acquisition unnecessary.

- Corporate relations - Japanese businesses often hold some of each other's equity as a symbol of their business ties. These shares are not sold as long as the partnership lasts. Although only a token amount most often is involved, a single company with many business relationships can have a significant amount of such goodwill stock. In cases where a firm depends a great deal on another company, a substantial portion of the dependent firm's stock often is held by the other business. A classic example is the Japanese automotive industry where the top firms, such as Toyota Motor Corp. or Nissan Motor Co., Ltd., often have representatives on the boards of subcontractors and parts suppliers by virtue of cross-stockholdings. In addition, until recently banks required matching collateral from borrowers before making a loan; many firms fulfilled this commitment with their shares, further decreasing the percentage of stock available to the public. Finally, several groups of Japanese firms are linked through stockholdings and business dealings. Although the cohesiveness of these keiretsu is slowly eroding (see JEI Report No. 2A, January 12, 1990), their tradition of cross-shareholding makes members resistant to takeover bids.

Although not the same as cross-stockholding, the investment strategies of insurance companies and trust/pension fund managers also reduce the pool of publicly traded shares. Because these firms are interested in long-term dividend income, they tend to hold shares rather than actively trade them. These institutional investors form an important part of a company's "stable shareholders" that actively and closely consult with the firm's management. Not only do these stable shareholders help the firm with its long-term development, but they also can play a decisive role in defeating hostile takeover bids. At the same time, though, they can put great pressure on management to accede to a merger or an acquisition if they feel it is in their best interest.

Both cross-stockholding and stable shareholding sharply reduce the percentage of a company's shares traded on the open market. In many cases these two groups constitute at least two-thirds of a firm's shareholders. This has proved to be an extremely effective defense against hostile bids. This defense evolved partly because Japanese laws bar a holding company structure, a common takeover barrier in the United States.

These stockholding patterns have not prevented stock speculators from prospering in Japan. In fact, "greenmail" -- forcing a company to pay inflated prices to buy back shares that were covertly purchased by a hostile outsider -- is well-entrenched in Japan. Although greenmailers have a distasteful image among mainstream businesses, Tokyo has done little to stamp them out.

- Social attitudes - Although a nebulous factor, cultural views nonetheless have very effectively helped to deter the introduction of American-style mergers and acquisitions in Japan. Japanese society is organized around groups, not individuals, and the company occupies a position near the top of society's hierarchy. To Japanese managers and employees a company is a living social unit, sometimes more important than the family, and can command a high degree of employee loyalty and management paternalism. Buying and selling companies based solely on financial considerations runs counter to this viewpoint, and sentiment against a takeover bid can be intensely personal. Even when a merger is friendly, the two firms often have great difficulty integrating because loyalties are extremely difficult to transfer (see, for example, JEI Report No. 35B, September 15, 1989).

Americans long have accepted mergers and acquisitions as a legitimate tool to grow and/or diversify. This tradition is not only weak in Japan but an opposing viewpoint actually is more prevalent. Merging is seen as a last resort to avoid bankruptcy, as mentioned above. Accepting a merger or an acquisition proposal is tantamount to announcing publicly that management has failed to do its job. To the intensely competitive Japanese, this is a form of surrender. The Japanese reaction to the purchase of Sansui Electric Co., Ltd. by Britain's Polly Peck International (Holdings) BV, for example, stressed the weakened condition of the electronics company rather than the opportunities for globalization.

Finally, American manufacturers and financial firms focus almost solely on the bottom line when evaluating corporate strategies. The American M&A market boomed in the 1980s because it was highly lucrative to all parties involved. Anything that made money seemed then to be acceptable to American businessmen. Japanese business has criticized this "money chasing money" attitude severely. Making products traditionally is the unchangeable first order of business. Unless the situation were dire, a respectable Japanese manager would not even consider M&A as part of his business plan.

All these factors combined to make mergers and acquisitions legally difficult and socially distasteful in Japan up until the 1980s. It is no surprise that foreigners interested in M&A as an entree to Japan's markets met with little success.

A Changing View

Beginning in 1980, however, significant shifts in all of the above mentioned factors plus other new developments forced Japanese corporate planners to reevaluate M&A.

- Legal environment - The 1980 revision of the Foreign Exchange Control Law reversed, in de jure terms at least, Tokyo's treatment of foreign direct investment, both inward and outward. Such transactions became "free in principle" with restrictions applying only in special cases for investments in Japan. Until 1984, however, the scope of "special cases" was so broad that the old and the new foreign exchange regulations differed little with regard to foreigners hoping to purchase a Japanese firm.

In May 1984 the United States and Japan concluded an agreement that still reverberates today. The report of the Joint Japan-U.S. Ad Hoc Group on Yen/Dollar Exchange Rate, Financial and Capital Market Issues set Tokyo on a path of financial liberalization that included easing foreign exchange and foreign direct investment rules. The cumulative impact of this pact, known as the yen-dollar accord, has been to allow foreigners to invest in all but a handful of domestic firms (mainly those considered vital to national security), to make government approval of inward foreign direct investment applications automatic in most cases, and to make the approval process more transparent if foreigners encounter difficulties.

One direct consequence of Tokyo's financial market reforms is to make mergers in the banking sector much more likely in the coming years. A plan by the Ministry of Finance to eliminate gradually the regulations that now prevent head-to-head competition by different categories of banks is forcing smaller banks to explore mergers to compete and is generating interest in acquisitions among larger banks interested in quick expansion. MOF's effort to allow banks and securities firms to compete directly against each other in certain markets as well as to give nonbank financial institutions greater leeway to enter new markets presages a shakeout in Japan's financial sector in which M&A will play a major role.

From a broader standpoint the liberalization and deregulation of Japan's financial markets has put new pressures on businesses and investors, particularly by making available instruments that yield comparatively high returns and by opening new opportunities for foreigners and Japanese alike. With savers demanding a higher return on their money, borrowers must pay greater attention to short-term profits instead of accepting a meager present return in hopes of long-term profits. Access to funding sources not controlled by the government has given Japanese and foreign firms the freedom to use the money in ways that bureaucrats may not approve, including mergers and acquisitions.

- Economic factors - Although the Japanese economy still outperforms its Western peers in terms of the inflation-adjusted annual growth of gross national product, its average performance in the 1980s (under 5 percent a year) was below the levels of the 1960s (around 10 percent) and 1970s (just above 5 percent). Besides raising the chances of bankruptcies (and therefore mergers), slower growth coupled with greater pressure to produce profits has forced Japanese management to consider all business options, even M&A.

The yen's appreciation against the dollar and other currencies between 1985 and 1988 combined with Tokyo's desire to emphasize the role of domestic demand to power growth have led to an on-going restructuring of the domestic economy. According to Japan's Fair Trade Commission, consolidation and reorganization of subsidiaries is one factor behind the jump in domestic mergers in the past few years. The yen's rise also has added pressure to pursue M&A in two other ways; a stronger yen has cut Japan's international competitive position but reduced the apparent cost of foreign assets. The frantic response by Japanese businessmen to the negative impact of the yen's rise is a major factor behind their reassessment of M&A. Given the yen's rapid ascent, Japanese corporations did not always feel they had the luxury of diversifying or building an overseas presence from scratch. Purchasing an existing firm provided instant relief. The enhanced overseas buying power of the yen made foreign mergers and acquisitions a very sound move from a financial standpoint.

- Corporate ties - Although no one expects the practice to be eradicated, the tradition of cross-stockholding is eroding a bit in Japan. Heightened pressure to generate profits has hardened banks' attitudes toward long-time corporate clients seeking the best possible deal on a loan. Banks also have been tempted to sell some of their vast stockholdings to boost profits, a maneuver that would have been unthinkable 10 years ago. More intense competition also is driving wedges between traditional business partners in some cases, again weakening the underlying reason for cross-stockholding.

The nascent Japanese debate over stockholder rights adds another wrinkle. Japanese corporations traditionally have paid low dividends, arguing that stockholders would benefit most from reinvestment of profits leading to long-term capital gains. Small shareholders were expected to be silent partners, never questioning management decisions or demanding bigger dividends. Defensive moves by two Japanese department stores in 1989 against a merger proposed by a major stockholder shattered this complacency. The merger targets sold each other newly issued shares to thwart the outsider. Since the share prices were unrealistically low, a court ruled that the defense ran counter to the interests of stockholders and was illegal. The unprecedented decision may mark the beginning of a shareholders' rights movement in Japan, a development that could break the Japanese M&A market wide open.

- Social factors - Changes in regulatory and economic factors are being reflected in slowly shifting attitudes about M&A. Although the Japanese phrase for takeover bid also can mean "hijack," mergers and acquisitions are shedding their unfavorable image. This applies particularly to large Japanese companies that are becoming true multinational corporations. M&A is an accepted practice outside Japan, and Japanese businesses realize they would be handicapping themselves if they did not include it in their global business plans. Nevertheless, Japanese corporate executives are approaching overseas M&A in their own way, focusing on friendly takeovers. Only a few Japanese companies have attempted or succeeded in launching a hostile bid overseas.

At home the attitude toward M&A is changing very slowly. Company loyalty has taken a beating as personal fulfillment and concern over the quality of life have increased in importance, weakening antitakeover sentiment. The Japanese also are losing their distaste for making money by financial wheeling and dealing, thanks in part to the stock market's boom through 1989 and the surge in real estate prices. Hard-nosed financial management is accepted as a component of a successful business strategy, although pure speculation still is viewed as unhealthy. These changes hardly represent a revolution, but they do show that change is taking place.

Another Arrow in Japan's Quiver?

The integration of the Japanese economy into the global market has raised the competitive pressure on Japanese companies. As more companies are discovering, mergers and acquisitions are powerful additions to their box of business tools.

Japanese M&A activity in the United States arises from three different motives:

- Building a local presence - To reduce reliance on exports (and the associated trade frictions) and to overcome the negative effects of the yen's appreciation, Japanese companies have embarked on a drive to localize production around the world. Whether a firm wishes to remain within its traditional line of business or is interested in diversifying, M&A offers quick results. Aided by the openness of publicly traded American companies and by the shortage of savings, which affects all firms private or public, Japanese companies have found willing sellers in the United States.

- Boosting profits - Japanese lenders have eyed hungrily the comparatively rich returns that M&A can generate. Hesitant at first, Japanese lenders with their large capital resources have become key elements in American megadeals. Such passive participation appeals to risk-averse Japanese fund managers with little experience in M&A. As their familiarity with the product and the process grows, however, Japanese lenders increasingly will seek out M&A opportunities.

- Gaining experience - Japanese banks and securities firms are not only interested in providing the funding for American M&A deals but are keenly interested in learning how to manage such transactions. Major Japanese banks and brokerage houses have established ties to American M&A specialists both to learn about the U.S. market and to bring this American expertise to the Japanese market. Some pessimists are worried that Japanese entrants will usurp the leading M&A position of American firms, a fear Japanese companies are trying to allay by focusing on building long-term cooperative relations with their U.S. partners.

Although they have learned much, Japanese businesses cannot yet match the dealmaking prowess of American advisers. This is clear in Europe, where an M&A boom is in progress in advance of the European Community's plan to integrate its member economies more fully beginning in 1992. European firms have sought out American advisers both to pursue and defend against this wave of mergers and acquisitions. A few Japanese companies are interested in using M&A to gain a foothold on the continent before 1992 but are daunted by their lack of familiarity (compared to the United States) with the European market.

Lost in the debate over the magnitude of Japanese M&A activity is whether the approach will really benefit Japanese companies. While providing an instant presence, M&A has drawbacks that pose totally new challenges to Japanese managers. There is no guarantee, for example, that the foreign acquisition will prosper under Japanese management. This is a particular problem for Japanese firms using M&A to diversify. Keeping the previous local management may forestall immediate chaos but also may prevent necessary changes from being implemented. A more serious task is to successfully integrate the acquisition into the parent company. Because the head office is half a world away and using a different language, integration is proving very difficult. American employees can feel left out of major decisions or limited in terms of career advancement. Japanese staff do not always become active members of the local community.

Failure to address these issues combined with the sharp growth of Japanese mergers and acquisitions in the United States has generated an unexpected backlash from Americans against Japan. Quite correctly, Japanese corporate executives point out that they are not the only ones buying American companies and are not even the largest owners of U.S. firms. American fears are not rational but cannot be ignored. This psychological issue may be the most difficult to solve.

Outlook

The American uproar over "aggressive" Japanese takeover activity has made Japanese businessmen much more cautious about making highly visible investments in the United States. In addition, the American market for high-risk bonds issued to finance leveraged buyouts (junk bonds) has run into a few highly visible failures that have put a damper on M&A activities. The slowing U.S. economy also has an effect on the growth potential of an increasing number of firms involved in LBOs in the 1980s. These negative factors should slow Japanese financing of M&A activity in the United States.

Nevertheless, continuously growing demands for capital by U.S. companies will force American managers to keep an open mind about overtures from Japan. The current negative atmosphere is daunting but will not stop Japanese corporations from pursuing plans to localize production to service overseas markets and to diversify abroad. Japanese companies are likely to focus more than ever on friendly takeovers. Whether Americans like it or not, the two economies will become ever more intertwined, and mergers and acquisitions will be an important vehicle of change.

M&A in Japan faces a more uncertain future. While the Ministry of Finance has initiated some steps that give takeover bids a greater chance of succeeding and is exploring other measures, many barriers lie outside of the government's reach. Cross-shareholding, a disregard for shareholders' rights and continued social denigration of mergers and acquisitions make it very unlikely that Japan will ever have a freewheeling M&A market. For the most part this suits the Japanese business community fine since it believes that merger-mania helped erode America's international competitiveness in the 1980s.

The future of hostile takeovers in Japan is dim, whether domestic- or foreign-initiated. T. Boone Pickens' attempt to force the management of a Japanese automotive parts maker to change its business plans by dint of his status as the largest stockholder has confirmed the disruptive nature of M&A in the minds of most Japanese. This does not mean that friendly bids will be spurned. Although most M&A bids among domestic firms are seen initially as unfriendly from the seller's perspective, if the deal makes sense for both sides and the suitor is persistent as well as sincere, good business sense will at least force serious consideration of the overture. This is particularly true of smaller Japanese companies facing the same difficulties raising capital and competing in foreign markets (and at home) as many American firms encounter in Japan. These smaller firms are open to alliances that will expand access to overseas markets and that give them an edge over domestic competitors. Both foreigners and Japanese agree that it is more difficult to conduct a merger or an acquisition in Japan than in the United States. It is not, however, impossible; those firms that can adapt themselves to the Japanese way of doing business usually have been successful.

For further information, contact Jon Choy.

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The views expressed in this report are those of the author and do not necessarily represent those of the Japan Economic Institute.

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IN THIS ISSUE:

Washington Pushes Tokyo On Public Spending 1
Land Prices Hit Record Highs In Major Cities 4
Senate Panel Examines DOD Defense Technology Programs 5
HDTV Update 7
Revision Of Antitrust Laws Pressed On Capitol Hill 9
USTR Updates List Of Foreign Trade Barriers 10
Notes: Provisional Budget 11

Washington Pushes Tokyo On Public Spending

Although no one is saying, American negotiators may have gotten the idea for a current trade initiative while waiting in Tokyo's main international airport, Narita. Bombarded with statistics and news stories about the Japanese economic juggernaut, Americans sometimes are surprised as they step off the plane at the relatively new facility. Compared to signs of unprecedented economic prosperity elsewhere in Japan, the country's airports and other public infrastructure appear neglected, at least to visitors from other industrial countries. Partly for these reasons, Washington has targeted public-sector investment as one of six broad categories under the Structural Impediments Initiative where it would like Tokyo to make major reforms. In particular, the United States is pressing Japan to increase fixed investment spending by the public sector to 10 percent of gross national product from the 6.5 percent level reached in calendar 1989 and expected for fiscal 1989, which ended March 31 (see Table 1). Such an increase would reverse a downward trend that had been expected to persist at least through FY 1990.

Table 1: Public Sector Investment and GNP

(in billions of yen)

	Actual			Estimated	Projected
	FY 1986	FY 1987	FY 1988	FY 1989	FY 1990
Nominal Public-Sector Fixed Investment	Y22,499.4	Y24,498.0	Y24,807.3	Y25,900	Y26,300
Nominal Gross National Product	334,601.3	351,366.1	372,500.0	396,500	417,200
Public-Sector Fixed Investment as Percent of GNP	6.7%	7.0%	6.7%	6.5%	6.3%
Nominal Growth Rate of Public-Sector Fixed Investment	5.0%	8.9%	1.3%	4.4%	1.5%
Real Growth Rate of Government Fixed Investment	7.0%	9.4%	1.2%	n.a.	n.a.

Source: Economic Planning Agency

Public-sector fixed investment, for which no comparable U.S. figure exists, is a component of GNP (see Table 2). In contrast to government current expenditures and public-sector inventory investment, it consists of outlays for relatively long-lived assets, such as buildings and equipment. As such, it includes a portion of spending by government at all levels and by other public-sector organizations. For example, local government and public corporation expenditures on harbor improvements get counted as investment, while central and local government education spending is considered government current expenditures. Simply including all public-sector education expenses -- an investment in youth in the view of many economists -- would lift the figure above 10 percent for most recent years. The diffuse nature and necessarily arbitrary definitions of public-sector investment make reaching any particular target a less than straightforward exercise. The FY 1989 general account budget figure of Y6.2 trillion ($41.3 billion at Y150=$1.00) in public works spending accounted for only a small portion of all public-sector investment during the April 1989-March 1990 period, suggesting the need to increase a series of public-sector budgets should Tokyo agree to Washington's request.

Especially considering the complexity of the subject, many Americans would be tempted to argue that Japan's infrastructure is its own business. After all, Americans would not readily accept criticism of this country's highways and bridges despite domestic debate on this subject, in part because foreigners would be deemed inappropriate evaluators of the divided responsibility

Table 2: Government's FY 1990 Economic Outlook: Real Gross National Product

(percent change)

	Actual			Estimated	Projected
	FY 1986	FY 1987	FY 1988	FY 1989	FY 1990
Real Gross National Product	2.7%	5.4%	5.3%	4.6%	4.0%
Consumer Spending	3.4	4.5	5.0	3.2	4.6
Residential Construction	11.0	25.7	5.3	0.2	0.3
Private Capital Spending	4.3	10.1	17.3	14.5	7.3
Business Inventories	-52.6	64.9	28.6	19.0	4.6
Government Spending*	7.7	2.1	1.3	5.7	2.5
Exports of Goods and Services and Factor Income Received	-3.7	5.4	10.7	15.4	10.6
Imports of Goods and Services and Factor Income Paid	5.4	12.4	21.4	19.3	13.0

*Includes public-sector current expenditures, fixed investment and inventory investment.

Note: FY 1989 estimates and FY 1990 projections are based on the economic outlook endorsed by the cabinet February 28, 1990.

Source: Economic Planning Agency

for such projects among federal, state and local governments. Surely Americans would bristle should a foreign country put a dollar amount on any suggested improvements. However, the SII talks have given the United States and Japan an opportunity for just such exercises, especially when a plausible case can be made that seemingly domestic problems have international implications. Washington presumably put its argument in this broader framework: if public fixed investment spending increases, then Japan's surplus of savings over investment declines, other factors being equal, putting less pressure on investors to find profitable outlets for their funds overseas. Should overseas investment decrease, the demand for dollars weakens compared to yen and that raises the value of the Japanese currency, leading eventually to a smaller Japanese current account surplus.

Of course this scenario is full of "ifs." One of the most important uncertainties involves government spending and tax policy. The Ministry of Finance has a long-standing policy of reining in -- with considerable success -- Japan's budget deficit. It recently announced a five-year goal of limiting bond issues for construction to less than 5 percent of revenue in the general account budget (see JEI Report No. 12B, March 23, 1990), down from 8.5 percent in the proposed FY 1990 budget. If MOF persists in this objective, increased public investment would probably have to come out of the expansion in revenues as the economy grows, at the expense of other government spending, or from a tax increase. Except for the first, these alternatives are politically unattractive. In addition, none would fulfill Washington's presumed objective of reducing the savings-investment imbalance in Japan. An increase in spending not tied to the general account could have the result that Washington seeks while enabling MOF to meet its new goal on construction bonds, but the Finance Ministry probably would see this as taking a backward step in its effort to reduce the budget deficit.

In short, Washington wants broadly defined budget deficits in Japan to be larger; MOF wants them smaller. No wonder then that negotiators on both sides of the SII talks have been spending so much time in the past few months in the air -- and in crowded airports on both sides of the Pacific.

Douglas Ostrom

Land Prices Hit Record Highs In Major Cities

The problem of high land prices in Japan, one of the most serious economic concerns of the government in recent years, grew worse last year. The National Land Agency's January 1, 1990 survey of 16,865 sites across the country showed Osaka to be hardest hit by higher prices. Publication of the results was moved up to March 22 from April 1, the release date in the past for the benchmark price survey, in order to make the information available to the public in a more timely manner.

Osaka, the second-largest city in Japan, attracted speculative money in 1989 seeking another outlet besides too-expensive Tokyo, the NPA survey indicated. Prices for housing, commercial and industrial lots rose by record-high figures -- 56.1 percent, 46.3 percent and 53.4 percent, respectively. The survey reported that higher prices were not limited to Osaka but emanated from Tokyo throughout the country. In particular, some second-tier cities experienced significant increases. The central part of Sendai, the largest city in northern Japan, recorded a 37.3 percent price hike in 1989 because people apparently decided to move there from crowded and expensive Tokyo. Land in Shizuoka prefecture, within commuting distance of Tokyo by high-speed trains and close to an ocean resort, jumped in price more than 20 percent. A 30 percent hike was reported in Yamanashi prefecture, west of Tokyo, where an experimental linear magnetic railroad is expected to be built. Jumps such of these helped to boost the nationwide average increase in the price of land for housing by 17 percent last year, much higher than the 7.9 percent rise in 1988.

While this domino effect has been observed before (see JEI Report No. 39B, October 13, 1989), the government was surprised that the price of housing sites in Tokyo went up 6.6 percent in 1989 compared to the stable 0.4 percent increase recorded the year before. This phenomena ignited fears that the tidal wave may wash back over Tokyo once the ripple effect has subsided in local areas.

Prime Minister Toshiki Kaifu called a ministerial meeting March 23, one day after NLA released the price survey, and reportedly suggested that the government take quick, restrictive actions, including implementation of a price freeze in major cities by instituting government control over land transactions. The government introduced a land price monitoring system in 1987 as an amendment to the National Land Use Planning Act to cope with speculative land activities. Under this system governors can designate some parts of their prefectures for monitoring; people who want to purchase land in these areas must comply with more extensive filing requirements. Prime Minister Kaifu's proposal for price controls is an indication that the monitoring system alone has not been able to restrain price increases.

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JAPAN · ECONOMIC · INSTITUTE

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REPORT

A Two-Part Report: A and B

NO. 15A April 13, 1990

JAPAN AND LATIN AMERICA

Summary

Japan, expected to play a leading role in alleviating the debt crisis in Latin America, has not had particularly broad-based ties with the region. Trade is modest, but imports have risen, shrinking Japan's surplus with the area to about half a billion dollars a year. Japanese foreign direct investment is centered in a few countries, primarily those known as tax havens. The uncertain political climate, both regionally and in individual countries, deters investments, while laws, such as those based on protecting infant industries, restrict trade. Japan is likely to continue to slowly strengthen its ties with Latin America, but the region is likely to find itself vying with Eastern Europe for Japanese investment and trade opportunities.

Overview

Latin America -- Central America, South America and the Caribbean -- has been the traditional backyard sphere of interest of the United States as exemplified by the Monroe Doctrine, which claimed the Americas for Americans. But the former financial paternalism exercised by Washington in the area has been changing as the United States tightens up its aid programs, a reflection of its own fiscal difficulties. The problems facing Latin America -- the debt crisis, drug cartels, civil wars, poverty -- are of such magnitude that the United States appears unable to maintain the dominant leadership role it once had in the region. Washington increasingly is looking to multilateral solutions and in particular a stronger role by Japan.

Japan's links to the region have been weak, with Brazil a notable exception. Japan in the past has concentrated on Southeast Asia, which had cheaper supplies of natural resources and lower labor costs than Latin America, where inflation and political upheavals also have combined in most countries to discourage large investments. Brazil, however, has developed close ties with Japan, starting with fortune-seeking immigrants who arrived at the turn of the century and kept coming until Japan's economic juggernaut took shape. The enclaves of Japanese and their descendants -- now approximately 1.2 million people -- have been relatively prosperous. Given economic differences between the two countries today, however, a reverse migration of Brazilian-Japanese workers has developed, with these immigrants taking on the dirty, difficult and dangerous jobs that the more prosperous Japanese worker shuns today.

As a part of Japan's view of its growing international responsibility as the leading creditor nation, Tokyo is looking to help find a workable solution to the Third World debt crisis. Japan may even look toward Latin American economic recovery as a way to help ease U.S.-Japan trade problems by encouraging stronger markets in the region, which could absorb more exports from the United States.

Foreign Investment

Japan's interest in Southeast Asia is well-known; these close-to-home markets enable low international transportation costs. Japanese direct investment in Latin America, however, actually outpaced the flow of money going into Asia in four of the last five fiscal years. Cumulative Japanese investment in Latin America of $31.6 billion through March 1989 was almost equal to the $32.2 billion total for Asia (see JEI Report No. 31A, August 11, 1989) and topped the $30.2 billion invested in Europe. Japan's $75.1 billion direct investment stake in North America, however, greatly outweighed that in other regions.

Japan's $26.1 billion in nonmanufacturing investments in Latin America is approximately five times the investment in the manufacturing sector (see Table 1). Nonmanufacturing investments are concentrated in banking (40 percent) and in transportation (35 percent). Japan has little invested in other sectors.

The Latin American investment figures are somewhat skewed, however, because of pockets of concentration that have important implications for Latin America. The majority of Japanese money is invested in Panama, which had $12.9 billion in Japanese investment at the end of FY 1988 compared with the $5.6 billion funneled into Brazil (see Table 2). The funds in Panama primarily represent the registration of vessels by Japanese shipping companies; some money also has gone into the banking sector. The Caymans, like many of their Caribbean neighbors, are known for the many tax shelters established there. The Caymans are host to $5.1 billion in investments from Japan, while the Bahamas are home to $2.7 billion.

Aside from these tax havens and Brazil, Japanese businesses generally have been hesitant to invest in Latin America. Rapid or even runaway inflation in many countries lowers profits in yen terms. Problems caused by inflation can

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Table 1: Japan's Foreign Direct Investment in Latin America by Industry Through March 1989

(in millions of dollars)

Manufacturing Sector	$5,437
Food Products	223
Textiles	439
Wood and Paper Products	200
Chemicals	590
Metals	1,933
Nonelectric Machinery	378
Electric Machinery	491
Transport Equipment	1,050
Other	132
Nonmanufacturing Sector	26,111
Agriculture and Forestry	190
Fisheries	146
Mining	1,557
Construction	208
Trade and Sales	1,508
Banking, Finance & Insurance	10,990
Services	931
Transportation	9,236
Real Estate	142
Other	1,203
Branch Offices	45
Other Transactions*	23
Total	31,617

*Certain overseas real estate transactions have been excluded from Japan's foreign direct investment data since December 1, 1980.

Source: Ministry of Finance

be compounded when a country has rules limiting the repatriation of profits. Political instability and uncertainties about nationalization of companies further discourage investments.

One major exception is Mexico, which has had some success in recent years in attracting Japanese investment because of the provisions for maquiladora plants along the U.S. border. Mexico exempts factories in maquiladora zones from some of its local-content and export requirements in exchange for investments, while the United States charges duties only on the value added to products assembled at the plants from American-made parts and then reexported to this country (see JEI Report No. 31A, August 11, 1989). Some analysts have predicted that Japanese investment in maquiladora plants will reach $3 billion by 1991. Maquiladora facilities, which can be 100 percent foreign owned, have led the way for further liberalization of foreign investment in Mexico.

Table 2: Japan's Foreign Direct Investment in Latin America, FY 1984-FY 1988

(in millions of dollars)

Country	FY 1984	FY 1985	FY 1986	FY 1987	FY 1988	Total as of March 31, 1989
Panama	$1,671	$1,533	$2,401	$2,305	$1,712	$12,858
Brazil	318	314	270	229	510	5,596
Caymans	1	132	930	1,197	2,609	5,085
Bahamas	97	298	792	734	737	2,718
Mexico	56	101	226	28	87	1,671
Bermuda	29	148	16	36	337	991
Netherlands Antilles	66	62	66	199	172	747
Peru	6	10	--	1	--	696
Latin America*	2,290	2,616	4,737	4,816	6,428	31,617

*Including Caribbean and other regional territories.

Source: Ministry of Finance

In addition to the current, significant investments in mining operations and in steel and nonferrous metals, particularly aluminum, Japanese investment in Latin America is expected to increase in such product groups as consumer electronics and telecommunications equipment. Consumer electronics products primarily would be manufactured in such countries as Argentina for a third-country export market, primarily the United States and Europe. Japanese companies also are interested in the potential telecommunications systems market in Brazil.

Using Japan's technology and engineering know-how some businessmen proposed last summer exploring the possibility of building an interoceanic canal, similar to the aging Panama Canal. The concept of a Nicaraguan canal dates from the last century, but analysts expect little tangible progress will be made on the project. Japanese businesses also are considering the possibility of constructing a land bridge in Colombia to facilitate cargo traffic between the Atlantic and the Pacific.

Trade

Japan's historic trade surplus with Latin America has been shrinking steadily since reaching $3.3 billion in 1986 (see Table 3). Last year the gap between exports and imports totaled just over half a billion dollars. However, the country continues to run a big deficit in trade with South America totaling $3 billion in 1989, reflecting Japan's demand for agricultural and industrial inputs and energy-intensive products and perhaps indicating import restrictions in some South American countries.

For example, several South American countries are major suppliers of nonferrous metals to Japan, including Chile ($446 million in 1989 or one-third of its Japan-bound sales), Venezuela ($400 million, a full three-fourths of

Table 3: Japan's Trade with Latin America, 1985-89

(in millions of dollars)

Country	1985		1986		1987		1988		1989	
	Exports	Imports	Exports	Imports	Exports	Imports	Exports	Imports	Exports	Imports
Central America	$4,580.1	$2,146.5	$4,499.5	$1,771.7	$4,141.7	$1,857.9	$4,710.4	$1,917.2	$4,745.5	$2,034.0
Belize	3.3	0.9	1.9	0.4	5.4	0.4	19.7	0.9	10.8	8.4
Costa Rica	85.2	6.7	99.5	13.7	104.6	14.6	60.4	18.6	94.0	22.3
El Salvador	43.2	39.4	33.0	33.9	59.3	29.1	41.2	29.5	42.0	17.5
Guatemala	51.0	39.7	45.4	57.8	78.1	27.3	72.6	34.2	76.7	45.6
Honduras	46.7	48.9	70.3	100.1	64.9	63.1	71.3	63.5	76.6	104.1
Mexico	994.0	1,869.9	1,032.0	1,439.0	1,388.9	1,625.2	1,772.3	1,590.7	1,907.7	1,729.9
Nicaragua	23.3	59.5	9.5	42.2	13.8	29.2	13.4	43.0	17.3	21.2
Panama	3,326.1	81.3	3,196.8	83.7	2,416.4	68.4	2,652.6	136.5	2,512.1	84.9
Canal Zone	7.3	0.2	11.1	0.1	10.3	0.1	6.9	0.0	8.3	0.1
South America	2,219.9	3,786.9	3,181.7	3,997.8	3,182.5	4,018.1	3,161.5	5,856.0	3,216.7	6,251.9
Argentina	225.4	443.0	361.0	503.3	443.4	299.6	298.2	495.0	176.3	416.9
Bolivia	46.7	9.3	28.7	8.8	47.5	9.3	26.3	18.3	37.6	16.4
Brazil	614.9	1,840.2	973.1	1,874.6	878.8	2,032.4	998.1	2,950.4	1,310.2	2,999.3
Chile	168.6	533.7	294.4	534.6	352.9	616.7	367.6	1,022.5	635.9	1,322.1
Colombia	422.1	150.4	385.9	267.1	388.2	220.7	526.7	296.2	489.4	288.6
Ecuador	173.6	48.0	271.1	77.7	216.8	70.8	115.8	85.3	113.9	106.0
French Guyana	7.7	5.6	10.5	5.5	5.3	7.5	6.4	6.0	6.5	2.4
Guyana	6.8	13.2	17.3	11.5	8.7	8.6	11.1	7.2	9.6	10.1
Paraguay	34.9	8.6	60.6	6.2	77.7	21.8	96.0	51.5	98.4	18.1
Peru	140.6	331.9	224.3	326.0	217.0	326.1	118.3	413.0	77.6	495.0
Surinam	9.7	9.5	8.4	28.2	5.3	27.4	9.2	22.3	10.6	17.7
Uruguay	16.8	25.8	30.4	19.0	35.6	21.8	33.4	25.9	39.4	24.9
Venezuela	352.1	367.7	516.0	335.3	505.3	355.4	554.4	462.4	211.3	534.4
Other Countries*	1,685.8	308.8	1,813.3	424.1	1,436.2	479.4	1,424.8	539.7	1,418.6	584.7
Total	8,485.8	6,242.2	9,494.5	6,193.6	8,760.4	6,355.4	9,296.7	8,312.9	9,380.8	8,870.6

*Including Caribbean and other regional territories.

Source: Japan Tariff Association

Japanese imports from that country), Brazil ($352 million) and Peru ($226 million). Chile and Peru also are important sources of nonferrous scrap. Japan's $3 billion in purchases from Brazil last year were more diversified but were topped by iron ore ($787 million) and steel ($631 million). The composition of imports from Mexico, with which Japan had a trade deficit until 1988, is similarly skewed toward intermediate products, notably oil. The $959 million in Mexican crude bought in 1989 represented 4.5 percent of Japan's supplies.

Japan's exports to Latin America consist primarily of machinery and transportation equipment, but this product slant largely reflects the fact that shipping lines send their vessels to Panama for registration. More typical is the mix of products bought by Mexico and Brazil, the top two Latin American markets for Japanese exporters. Among the $1.9 billion in goods Mexico purchased in 1989 were steel ($123 million), fabricated metal products ($63 million), nonelectric power-generating equipment ($78 million), computer equipment ($56 million), semiconductors and electronic tubes ($176 million) and videocassette and audio recorders ($51 million). The $1.3 billion in products exported to Brazil last year was made up in part of computer equipment ($40 million), electric power-generating equipment ($36 million), semiconductors and electronic tubes ($134 million), scientific equipment ($43 million), watches and clocks ($39 million) and videocassette and audio recorders ($62 million).

Foreign Aid

The United States has been critical of Japan for not taking more initiative worldwide in leadership and burdensharing roles. Foreign aid has been one issue on which recent prime ministers have staked Japan's reputation. Former Prime Minister Noboru Takeshita announced at the June 1988 economic summit meeting of the seven leading industrial democracies that Tokyo would begin a fourth aid-doubling plan to disburse $50 billion from 1988 to 1992 (see JEI Report No. 41A, October 27, 1989).

For Latin America the increase in Japanese spending has meant more aid in dollar terms but a shrinking share of the pie. Official development assistance to Latin America rose from $229 million or 9.4 percent of the total in 1984 to $399 million or 6.2 percent in 1988, although this was a slight drop in dollar terms from the $418 million given in 1987 (see Table 4). (Figures for 1989 will not be released until later this year.) In contrast to Latin America, aid to Africa rose from $221 million or 8.7 percent in 1984 to $884 million or 13.4 percent four years later. This increase reflects Japan's policy of giving a larger share of its aid money to the world's poorest countries rather than to middle-income developing nations, which is the rating given many countries in Latin America by the Organization for Economic Cooperation and Development.

The top recipient in Latin America in 1987 -- the most recent year for which comparative data are available -- was 15th-ranked Brazil, which received 0.9 percent of Japan's foreign aid. Mexico was in the number 17 slot with 0.8 percent of the total. Bolivia, Paraguay, Peru and Honduras rounded out the positions from 21 to 25. In contrast, the United States had three Central American countries as top-10 recipients -- El Salvador in third, Honduras as number seven and Costa Rica at 10. In Washington's second tier of 10 Latin America took half of the positions. Mexico and the Dominican Republic ranked in the bottom of the top-25 recipients. Despite Washington's strong interest in Latin America only Martinique at number 19 and El Salvador in the 20th position

Table 4: Japan's Official Development Assistance to Latin America, 1984-88

(in millions of dollars)

Country	1984	1985	1986	1987	1988
Central America	$50.6	$42.3	$128.5	$86.6	$104.7
Belize	--	0.0	0.3	0.0	0.1
Costa Rica	0.9	0.6	2.8	4.8	6.3
El Salvador	-0.8	-3.5	-0.1	3.4	2.1
Guatemala	1.5	1.3	2.6	2.5	4.4
Honduras	13.7	18.9	36.2	35.0	48.1
Mexico	30.6	19.5	80.8	35.0	38.8
Nicaragua	0.1	0.1	0.2	0.3	0.4
Panama	4.6	4.1	5.7	5.6	4.5
South America	154.9	140.6	159.8	298.1	245.5
Argentina	8.7	8.4	16.2	20.2	26.0
Bolivia	29.6	22.6	23.8	53.8	35.3
Brazil	35.6	40.6	32.3	82.1	66.4
Chile	1.7	6.7	5.4	9.7	15.0
Colombia	24.6	13.9	7.2	4.5	6.7
Ecuador	2.0	1.9	2.9	46.1	16.1
Guyana	2.2	3.4	3.1	0.8	2.0
Paraguay	23.0	18.9	34.0	39.3	43.6
Peru	24.9	21.5	32.3	37.6	28.4
Surinam	-0.1	-0.1	-0.4	-0.1	-0.4
Uruguay	1.8	1.7	1.5	2.1	3.2
Venezuela	0.9	1.1	1.5	2.0	3.2
Other Countries*	23.5	42.1	28.7	33.3	49.1
Total	229.0	225.0	317.0	418.0	399.3

*Including Caribbean and other regional territories.

Source: Ministry of Foreign Affairs

ranked among the top-25 recipients of the OECD's Development Assistance Committee.

Honduras and Mexico are by far the largest recipients of Japanese aid in Central America. Their respective totals in 1988 of $48.1 million and $38.8 million far outpaced the figures for the third-largest recipient, Costa Rica, which received only $6.3 million that year. In South America the top destination for Japanese assistance in 1988 was Brazil with $66.4 million, followed by Paraguay with $43.6 million and Bolivia with $35.3 million.

Augmenting government efforts in foreign aid and debt recycling are private-sector initiatives. Japan International Development Organization Ltd., a group established in 1989 and run by Keidanren (Japan Federation of Economic Organizations) tries to involve businesses in Third World economic development. JAIDO projects help countries earn foreign exchange through a multistep process. The first is the export of agricultural and industrial inputs, for example, fish. The second stage uses earlier profits to develop a value-added product or industry, such as building a fish processing plant.

In Mexico JAIDO has helped the Ritz Carlton hotel chain in a Cancun project to generate foreign currency through tourism. Other Latin American proposals under consideration include an ammonia fertilizer plant and a fish-processing operation in Argentina and a three-way trade to sell Venezuelan electricity to Trinidad and Tobago, which in turn would sell oil to Japan. JAIDO typically takes a 10 to 15 percent equity stake in projects; other money comes from Japanese companies, local firms and international partners. The average project size is approximately $33 million.

Debt Recycling

The debt crisis more than any other single issue has dominated the economic landscape of Latin America in recent years, officially beginning in 1982 when Mexico announced that it did not have adequate foreign exchange reserves to service its debt. As U.S. funds for bilateral foreign aid programs and multilateral institutions have become tighter and as American commercial banks slowly begin to write off losses on loans to Latin America, many eyes have been looking toward the capital-rich nation of Japan for leadership in debt recycling. Recent elections, including that of Brazilian President Fernando Collor de Mello, may put new economic muscle into previously weak fiscal policies that had failed to win international support -- and breathing room from multilateral lending agencies.

The Brady Plan, a debt-reduction concept authored by Treasury Secretary Nicholas Brady and remarkably similar to an earlier plan by former Japanese Finance Minister Kiichi Miyazawa, is the newest debt-relief idea for Latin America. The Miyazawa Plan was proposed in June 1988 at the Toronto economic summit but was received coolly by both the United States and West Germany (see JEI Report No. 38B, October 7, 1988). Mr. Brady implied that the Japanese plan was a variant of the Baker Plan, named after former Treasury Secretary James Baker (see JEI Report No. 29A, July 31, 1987). Mr. Baker's plan emphasized economic growth as the means to help developing nations repay debts. The concept included new lending to stimulate growth in conjunction with economic adjustment measures; that was in contrast with most other debt relief programs, which are conditioned on austerity.

Mr. Miyazawa's plan differed from Mr. Baker's by calling for a larger role to be played by international lenders like the International Monetary Fund. The IMF would have to sign off on the midterm economic plans of debtor countries and along with banks would have provided additional financing or loan rescheduling. Also, a portion of existing loans would have been converted into bonds at face value. The plan was criticized because many officials worried that foreign governments might be forced to fund a bailout by borrowers.

The Brady Plan, put forth in mid-March 1989, gained international support during the IMF interim committee meeting at the beginning of April 1989. Mr. Brady proposed reductions in the loan principal and interest charges as alternatives for reducing the debt burdens of Third World countries. Tokyo strongly backed the Brady Plan and announced that its Export-Import Bank would channel $4.5 billion to developing nations for debt relief over the next three years. While American banks hold the largest portion of Third World debt, Japan's Ex-Im Bank is expected to play a major role in alleviating the debts of lesser developed countries.

The Brady Plan's first customer was Mexico City, but the eventual agreement did not result in as much debt reduction as Mexico had hoped to achieve. Japanese institutions are the second-largest creditors after their American counterparts of the nearly $50 billion in outstanding public Mexican debt (see JEI Report No. 6B, February 9, 1990). A formal agreement signed in early February 1990 involves a complicated mix of new lending and debt-reduction bonds; it was particularly significant in that it forced Japanese banks to realize losses on a large portion of their Mexican loans.

Debt-reduction schemes in some Latin American countries have been slowed or halted due to changing administrations. Immediately after taking office March 15, Brazil's new president imposed stringent requirements aimed, among other goals, at checking rampant inflation, which during the first two months of this year soared more than 170 percent. Other reforms targeted a 10 percent reduction of the public-sector deficit. In the meantime, creditors of Brazil's nearly $115 billion in foreign debt wait to see how commercial banks and multilateral lenders react to Mr. Collor's plans. Japanese banks, estimated to hold between one-fifth and one-quarter of Brazil's external debt, have been asked by an international group of creditor banks to help develop a program to keep funds flowing to support Brazil's economy.

A key question facing Brazil is to what extent it should deregulate imports and inward foreign investment. Some analysts predict that if Latin American markets do not open further, investment dollars from Japan and other countries may go to the swiftly changing economies of Eastern Europe. Washington is pushing Tokyo to commit financial resources to both regions. But Japan is learning to tie its purse strings to political remuneration.

Politics

The early March summit with Prime Minister Toshiki Kaifu gave President Bush the opportunity to press Japan for a financial commitment to Latin America, particularly to help support the newly elected democracies of Panama and Nicaragua. Tokyo already was committed to helping Managua politically and financially through a United Nations contribution that included $500,000 for diplomatic observers to judge the fairness of the Nicaraguan elections. And Mr. Kaifu said Japan would look further toward providing reconstruction funds to the region in line with the area's moves toward peace. Since both Central American countries face dire economic straits, financial help is considered critical to the success of their democracies. In remarks following Mr. Kaifu's visit, President Bush said he felt Tokyo's assistance in Central America ". . . is very important. And, frankly, I think that will help the U.S.-Japan relationship."

In other ways, too, Japan is making its political presence known. For instance, former Prime Minister Takeshita represented Japan at the swearing-in ceremony for Mr. Collor, who earlier had visited Japan as part of a preinauguration tour to centers of world influence. Moreover, Tokyo has channeled some of its political leadership efforts in Latin America through international financial organizations, including the IMF, the World Bank's Multilateral Investment Guarantee Agency and the Inter-American Development Bank. While developed countries are willing to welcome Japan's additional financing through these organizations on top of Tokyo's bilateral foreign aid programs, they seem reluctant to yield the associated political clout in the region.

Conclusion

Tokyo's support to help solve Third World debt problems is vital. While the United States seems uncomfortable with the concept of powersharing -- particularly in its own backyard -- it needs the help of the world's largest creditor nation, Japan. The two nations are certain to continue to take the lead in working on an international solution, but national egos are sure to be hindrances. This has been most obvious in the case of Tokyo's request to leapfrog to the number-two quota and clout position in the IMF. On the corporate level Japanese businessmen are likely to retain stable but cautious ties with the region as they carefully consider rapid rises in investment and trade and weigh them against various countries' prospects for economic stability and growth.

For further information, contact Gretchen Green.

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The views expressed in this report are those of the author and do not necessarily represent those of the Japan Economic Institute.

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JAPAN · ECONOMIC · INSTITUTE
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REPORT

A Two-Part Report: A and B

NO. 16A

April 20, 1990

CAPITAL COSTS IN THE UNITED STATES AND JAPAN

Summary

What American and Japanese firms have to pay for their money is cited as a striking difference between the two economies by many analysts, who then conclude that the apparent Japanese advantage on this score has been a key determinant of the success of Japanese firms in international competition. Careful studies of the cost of capital reveal, however, that the differences are far smaller than superficial analysis would suggest, although most experts believe that the discrepancy in Japanese firms' favor does not disappear entirely. What would appear to be different management philosophies in Japanese firms may be a result of the remaining capital cost disparities.

As Japan's capital markets and businesses become more international in their operations, a number of factors suggest that the country's capital cost advantages are likely to diminish. Some analysts even have ventured that the dramatic decline in the Tokyo stock market during the first three months of 1990 eventually may be viewed as a historic juncture in this process.

Savings, Investment and the Cost of Capital

Japan's postwar expansion is notable in many ways, not the least of which is the country's extraordinarily high rates of savings and investment. The high savings rate of Japanese consumers compared to that of their counterparts in other industrial countries has created a pool of surplus funds that industry can tap to finance high levels of plant and equipment spending. In the absence of trade or budget deficits and surpluses -- which during most of the postwar period have been minimal relative to gross national product -- high rates of savings and high levels of investment were two ways of saying the same thing; one would not have been possible without the other. (For details of Japan's savings, see JEI Report No. 17A, May 1, 1987; for investment, see JEI Report No. 15A, April 14, 1989.)

The healthy volume of investment in Japan without doubt is a major contributing factor to the country's strong postwar growth rate, a virtually unbroken pattern of relative success that continues to this day. Various studies of Japan's high productivity growth rate, which has permitted ever larger national output, all point to capital formation as the overwhelmingly important factor. (For a discussion of productivity growth determinants in postwar Japan, see JEI Report No. 36A, September 22, 1989.)

Such analysis pinpointing the critical role of capital spending leads, in turn, to another question: what causes the high level of investment? Many analysts have said that Japanese firms spend large amounts on plant and equipment as well as on research and development in part because the cost of capital -- the pretax return expected on such projects -- has been low. As evidence they cite the low interest charges on borrowed funds and the low yield on corporate securities. This argument suggests that investors evaluate the rate of return on various possible instruments, such as bonds, stocks and bank savings deposits. The corporation has to appear likely -- or to promise, in the case of bonds and similar instruments -- to make enough on the proposed project and other projects to satisfy investors. Otherwise, investors will employ their money elsewhere. In other words, the cost of capital bears a close relationship to the interest rate. Other factors equal, the higher the interest rate, the higher the cost of capital.

Measuring the Cost of Capital

Given this argument, why doesn't a simple comparison of interest rates in Japan with those in the United States and other countries settle the cost of capital question? Unfortunately, meaningful figures are not readily available. Of course, compilations of interest rate numbers abound in the United States and Japan. Without adjustment, however, these figures carry little meaning.

Based on these unadjusted numbers, American businesses sometimes argue they cannot compete with firms from Japan because of low Japanese interest rates. They are correct about the low rates but may well be wrong about the implications. Very rarely during the postwar period have nominal Japanese interest rates been higher than those in the United States; often they have been much lower. For example, in late March 1990 long-term corporate bonds yielded 9.43 percent in the United States but only 7.44 percent in Japan. This gap actually was much narrower than at other times in the recent past when it had exceeded 4 percentage points. Similarly, short-term interest rates in Japan were lower in late March, when comparable three-month bills yielded 8.3 percent in the United States but only 6.4 percent in Japan. This occurred despite repeated efforts by the Bank of Japan in late 1989 and early 1990 to rein in the decline of the yen against the dollar in international currency markets by driving up the cost of borrowing in Japan.

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These figures obviously mean that a Japanese firm pays less in interest charges on a given dollar (or yen) of borrowed funds than an American company if each borrows in its domestic market. However, economists agree that such a statement by itself proves virtually nothing.

The effects of inflation pose one obstacle to judging interest rate differentials. If price increases are less in Japan than in the United States, as they generally have been in the 1980s, then the interest rate comparison is less in Japan's favor than it would appear. Adjustments for inflation would reduce the real cost of funds in the United States compared to Japan.

To see this point, consider the following example. Suppose that when a company seeks to obtain a loan it has a choice of servicing its borrowing with its output or with dollars. A steel company could repay its loan with steel, for example. (This example is not rare. Deals with centrally planned economies, such as China, sometimes involve servicing a loan with the production of the plant constructed with the loan.) If the price of steel goes up, the company's repayment in steel remains at the same number of tons. Alternatively, if the repayment is fixed in dollars, rising steel prices do not increase its dollar expenditures. A steel repayment scheme would be a fixed obligation in terms of the percentage of the company's output, but a dollar-based plan would necessitate selling fewer tons of steel to meet the contracted dollar repayment if prices should rise. In conclusion, dollar-denominated repayment schemes become less burdensome in the presence of inflation. Therefore, the typical loan where repayment is fixed in money -- rather than output -- becomes cheaper when the rate of inflation is higher, other factors equal.

With greater inflation in the United States than in Japan, American firms have experienced a considerably larger offset to their interest payments than have Japanese companies. Table 1 shows a very rough comparison of interest rates in the United States and Japan in recent years after making a crude adjustment for price increases in both countries. The gap between interest rates narrows as a result of adjusting for inflation, but it does not disappear completely. Note that in the early 1980s this measure actually showed real interest rates higher in Japan.

Return now to the present. During the 12 months through the end of February U.S. consumer prices rose 5.3 percent and Japanese consumer prices 3.6 percent. These figures would suggest that inflation-adjusted long-term rates based on the difference between long-term corporate bond yields and year-to-year consumer price changes are about 4.1 percent in the United States and 3.8 percent in Japan, while short-term rates are even closer. Such estimates obviously are very rough. For example, using past rates of inflation as an indication of future rates is always, at best, an approximation. Japan's annualized inflation rate over the recent December-February period was lower than the rate covering the past 12 months. If more current inflation rates are used, Japan's real interest rates would lie above those of the United States as of late March and early April.

Completing the Picture: Other Dimensions of the Cost of Capital

Most writers who concern themselves about the cost of capital stop here. As shown in Table 1, adjustments for inflation fail to completely remove the lower price of funds in Japan, with the 1980-81 period and early 1990 possible exceptions. More careful researchers add a number of other factors to reach a more sophisticated judgment.

Table 1: Yields on Government Bonds in Japan and the United States, 1980-89

	United States		Japan		Percentage Point Difference	
	Nominal	Real	Nominal	Real	Nominal	Real
1980	11.5%	-2.0%	9.2%	1.5%	2.2	-3.6
1981	13.9	3.6	8.7	3.8	5.2	-0.2
1982	13.0	6.8	8.1	5.4	4.9	1.4
1983	11.1	7.9	7.4	5.5	3.7	2.4
1984	12.5	8.2	6.8	4.5	5.7	3.7
1985	10.6	7.0	6.3	4.3	4.3	2.7
1986	7.7	5.8	4.9	4.3	2.7	1.4
1987	8.4	4.7	4.2	4.2	4.2	0.5
1988	8.9	4.9	4.3	3.6	4.6	1.3
1989	8.6	3.7	5.1	2.8	3.5	0.9
1989 - I	9.2	4.4	4.6	3.5	4.7	1.0
II	8.8	3.6	5.0	2.3	3.8	1.3
III	8.1	3.4	5.0	2.3	3.1	1.1
IV	8.0	3.3	5.7	3.0	2.2	0.3

Source: International Monetary Fund

Type of Financing - Not all forms of funding are created equal. Firms in both the United States and Japan usually finance their activities with some combination of debt, whether borrowed or raised on capital markets, funds raised by selling stock (new equity) or another form of equity, reinvested earnings. Differences between the United States and Japan in the cost of each of these sources of funds, as well as the various mixes of financing, contribute to distinctions in the overall cost of capital.

How to measure the cost of debt and equity is the first problem. For example, in the absence of inflation and other factors to be considered below, the cost of debt corresponds to the interest rate. However, what is the cost of newly raised equity or reinvested profits? Most often researchers apply a figure that the stock market has assigned -- the net income of a firm as a percentage of the market value of the firm's equity. (This figure is equal to the reciprocal of the price/earnings ratio familiar to stock analysts.) This suggests that if a company's stock is selling at $40 per share and the company is earning $8 per share, the cost of equity capital is 20 percent; the firm has to earn 20 percent on any planned investment financed with equity to meet the expectations of the stock market. Some researchers question, however, whether firms treat all forms of equity finance equally. For example, some U.S. companies have been accused of squandering retained profits on projects that yield far less than market rates of return for stockholders. This raises questions of whether their shareholders are indifferent to the return on reinvested income.

A second problem is the mix between equity and debt. Business page headlines in American newspapers routinely report soaring debt levels for U.S. corporations; Japanese firms, much less involved in leveraged buyouts, would appear to have much lower debt levels. If anything, the reverse is true, especially historically. In 1977 the book value of Japanese debt was almost four times that of equity valued at market prices; at the same time U.S. values were virtually one-to-one. In recent years the ratios almost have converged, mainly because Japanese firms are less leveraged than before -- in other words, relying less on borrowed money and bonds than on equity. By 1988 the U.S. ratio had risen to slightly more than one-to-one, while Japanese corporate debt had dropped to just over one-and-a-half times equity. Most experts believe, for reasons explained below, that debt has a lower net cost than equity in both the United States and Japan. To the extent that this is true, Japan's capital cost advantage, if any, probably is narrowing.

Tax Policy - Corporations have to pay taxes. Obviously, the higher the tax rate the lower their net income in the current period and, other factors equal, the less they can reinvest or return to stockholders in the form of dividends. A higher tax increases the pretax-required rate of return on projects. For this reason, taxes raise the cost of capital, other factors equal.

Taxes complicate other factors as well. For example, returns to equity and debt typically have different tax consequences. In arriving at their taxable income firms may deduct fully interest expenses but not income accruing to stockholders. This means that a company has to generate a higher pretax return on projects financed with equity than on those backed by debt in order to generate a return to investors that is comparable, other factors equal. Put differently, the higher the percentage of equity to debt as a means of financing for the firm, the higher the cost of capital.

The complications do not end there. In addition to interest expenses, companies are allowed to take certain other deductions in computing their taxable income. For firms contemplating investment perhaps the most relevant are depreciation charges. As equipment is assumed to wear out, firms can treat a portion of the original purchase cost as an expense. The more generous the tax code in permitting such action, the smaller the tax burden. In addition, lower prevailing interest rates work to reduce the tax burden by leading to smaller discounts on future depreciation provisions. (Future depreciation allowances are worth less than current ones because the firm does not have use of the tax savings until the depreciation is allowed and thereby loses the potential return on that money in the interim. Lower interest rates reduce the extent of that loss.)

Several Japanese experts argue that corporate tax rates are higher in Japan than in the United States. Hiromitsu Ishi of Hitotsubashi University finds that the average effective rate of corporate taxation in Japan generally has been higher than in this country since the mid-1970s, with the gap widening at least through 1984.[1] (Professor Ishi's study covers the 1970-84 period. As such, it does not reflect the important Tax Reform Act of 1986 in the United States.) However, John B. Shoven of Stanford University has argued in a number of papers that the effective marginal tax rate was still higher in the United States in 1989, although he acknowledges that effective Japanese rates adjusted for inflation rose during the 1980s much faster than comparable U.S. rates.[2]

[1] Hiromitsu Ishi, The Japanese Tax System (Oxford, England: Oxford University Press, 1989), pp. 157-201. Professor Ishi also reviews earlier studies of the same question.

[2] John B. Shoven, "The Japanese Tax Reform and the Effective Rate of Tax on Japanese Corporate Investments," Tax Policy and The Economy (National Bureau of Economic Research Working Paper No. 2791), 1989.

Risk - Not all projects are equally risky. If a lender senses a chance of default or a significant possibility of a much lower-than-expected return, it will demand a higher return to compensate for this prospect. Therefore, companies believed to be threatened by bankruptcy often have very low P/E ratios (and high rates of return). In general, bondholders, who would stand near the head of the line in the case of faltering profitability, demand less in compensation for their risk than do common stockholders, who would be practically last in line.

If borrowers and lenders know each other well, as is likely within corporate groups, the lender may perceive less risk, particularly if it has special access to relevant information about the borrowing company. Most experts think that such group-type relations are more common among Japanese financial and nonfinancial firms, with the financial keiretsu structure being a case in point. However, these analysts disagree over whether this factor has led to lower borrowing costs for members of financial-based business groupings. (For details on keiretsu, see JEI Report No. 2A, January 12, 1990.)

Finally, a record of past success may lift general expectations about future prospects; if default rates in the past in an industry or a country have been low, investors may expect similar results in the future and be willing to live with a low risk premium. With Japan's 40-year record of exceptional economic growth, lenders may feel comfortable about the unlikelihood of a macroeconomic disaster that would materially affect default rates or even expected returns. In the United States, which has suffered severe recessions during this period, such confidence levels logically would be far lower.

Studies of the Cost of Capital

As should be clear by now, measuring the cost of capital in Japan compared to the United States is a tough job. In fact, it is even harder than the previous section suggests because the various dimensions of cost interact in complex ways. For example, higher tax rates increase the capital cost of risky investments more than that of less risky projects. Hence, a system where taxes are high is likely to discourage investments with substantial exposure more than those with lower risk.

Studies of the cost of capital have come to disparate conclusions.[3] Albert Ando and Alan Auerbach, both of the University of Pennsylvania, examined the cost of capital of 40 large U.S. and Japanese firms for the 1966-81 period. After making many of the adjustments described above to the nominal cost of capital, they found little evidence that the cost of capital was lower in Japan during this time frame. Among other findings, they rejected the hypothesis that business taxation favors Japanese firms, a finding that would presumably still hold in more recent periods as Japanese tax burdens apparently have risen relative to American ones.[4]

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[3] For references to many such studies and a discussion of results in the context of competitiveness implications for U.S. and Japanese firms, see U.S. Congress, Office of Technology Assessment, Making Things Better: Competing in Manufacturing (OTA-ITE-443) (Washington, D.C.: Government Printing Office, 1990), pp. 93-112.

Robert N. McCauley and Steven A. Zimmer, in an article for the Federal Reserve Bank of New York, examined the cost of capital for the United States, Japan, West Germany and the United Kingdom for the 1977-88 period. After adjusting for taxes, inflation, differing equity/debt ratios and other factors, they found that Japan, in general, did have significantly lower capital costs than the United States and the United Kingdom, with a less clear-cut advantage over West Germany. As Table 2 shows, according to Messrs. McCauley and Zimmer, Japan had uniformly lower costs than the United States in every year for a wide variety of investments. This was a result primarily of low-cost equity; for half the years after 1980 the real, after-tax cost of debt was higher in Japan than in the United States, according to their analysis. In 1988, the most recent year considered, the real cost of debt financing in Japan was the highest among the four countries studied despite it having the lowest nominal interest rates.[5] Messrs. McCauley and Zimmer, along with other analysts, did not make adjustments for risk. They did not ask the question, for example, as to whether very risky projects had a lower cost of capital in Japan than in the United States.

Table 2: Cost of Capital for Various Projects in United States and Japan, 1980-88

(percentage point difference between U.S. and Japanese capital costs)

	1980	1981	1982	1983	1984	1985	1986	1987	1988
Equipment and Machinery with Physical Life of 20 Years	2.7	4.7	3.0	1.8	2.9	2.8	1.3	3.2	4.0
Factory with Physical Life of 40 Years	3.1	3.3	5.8	3.8	6.5	6.5	3.5	4.2	5.2
Research and Development Project with 10-Year Payoff Lag	5.1	0.3	10.1	6.5	12.6	11.0	7.4	9.8	11.6

Source: Robert N. McCauley and Steven A. Zimmer, "Explaining International Differences in the Cost of Capital," Federal Reserve Bank of New York Quarterly Review, Summer 1989, p. 16.

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[4] Albert Ando and Alan Auerbach, "The Corporate Cost of Capital in Japan and the United States: A Comparison" in John B. Shoven, (ed.), Government Policy Towards Industry in the United States and Japan (Cambridge, England: Cambridge University Press, 1988), pp. 21-49.

[5] Robert N. McCauley and Steven A. Zimmer, "Explaining International Differences in the Cost of Capital," Federal Reserve Bank of New York Quarterly Review, Summer 1989, pp. 7-28. The relative cost of debt among the four countries since 1977 is shown on p. 10.

B. Douglas Bernheim of Northwestern University and John B. Shoven of Stanford University in a recent paper took the risk factor more directly into account.[6] They found that corporate taxes increase capital costs more for risky projects than for relatively safe ones in the United States, while Japan's tax system is more neutral with respect to risk. Japan's corporate tax structure, in the view of Messrs. Bernheim and Shoven, discourages investment less than does the U.S. tax code. They concluded that Japanese firms generally have lower capital costs, as shown in Table 3; that conclusion particularly applies for risky projects.

Table 3: Cost of Capital in the United States and Japan, 1980 and 1988

(for plants; earnings/price basis and standardized risk)

	United States		Japan	
	1980	1988	1980	1988
Equity Financed	20.7%	12.6%	14.5%	5.1%
Debt Financed	16.7	9.7	7.4	3.0

Source: B. Douglas Bernheim and John B. Shoven, Comparison of the Cost of Capital in the United States and Japan: The Roles of Risk and Taxes (Stanford, California: Center for Economic Policy Research, 1989), Table 6.

For Messrs. Bernheim and Shoven, as with other researchers, the cost of equity financing in Japan proved particularly vexing. P/E ratios in Japan are remarkably high, even after various adjustments. This suggests, as was explained earlier, that earnings are low in relation to market value. Hence, firms would appear to have a low "hurdle" value for proposed projects financed with equity; with other factors being equal, that means a low cost of capital.

But is the matter that simple? The Japanese stock market went up significantly year in and year out during the 1980s before faltering early this year. Investors in Japanese companies did very well; their annual returns were far greater than those suggested by P/E ratios. To the extent that investors came to expect increasing stock values, a given company did what it could to increase its stock value to be competitive with other companies the investor might choose. Generally this meant choosing highly profitable projects that would raise the price of a company's stock. Hence, it could be argued that the relevant cost of equity capital is given more accurately by the realized percentage increase in the stock market price than by the earnings/price ratio. Messrs. Bernheim and Shoven, while preferring the earnings/price ratio as a criterion, nevertheless present the figures both ways. If stock market price increases are the standard, then the cost of equity capital would be higher in Japan than in the United States for equally risky projects in both 1980 and 1988, the two years they considered.

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[6] B. Douglas Bernheim and John B. Shoven, Comparison of the Cost of Capital in the United States and Japan: The Roles of Risk and Taxes (Publication No. 179) (Stanford, California: Center for Economic Policy Research, 1989).

In summary, Messrs. Bernheim and Shoven found lower capital costs in Japan than in the United States, with the advantage particularly noteworthy for risky projects. As such, their results are consistent with those of Messrs. McCauley and Zimmer, who used a different methodology, but they contrast with the findings of Messrs. Ando and Auerbach, which stem from a third methodology. None of these economists is likely to have the last word. As the world and the Japanese economies change, new factors, some of which receive recognition in the studies discussed above, are threatening to complicate the already complex task of accurately gauging capital costs.

Other Considerations

International Borrowing and Lending - Borrowers and lenders, even if their interaction produces lower capital costs in Japan, may not be able to reproduce their magic overseas. For example, if Japanese manufacturing firms gain an advantage as exporters because of lower capital costs at home, this advantage could disappear for products made by the same Japanese companies in this country. Such companies are subject to U.S. tax rates and depreciation provisions for their onshore production. Even if a manufacturer's debt and equity costs are the same in yen and dollar terms for its American and Japanese factories, the after-tax costs of capital may not be, depending on U.S. and Japanese tax provisions.

In some cases U.S. taxes could be more beneficial to Japanese companies than Japanese provisions. In those instances, however, Japanese firms are limited in their ability to benefit. American subsidiaries of Japanese firms, like their U.S. counterparts in Japan, have to deal with a tax code provision that gives them the worst of both worlds. Washington as well as Tokyo attempts to collect from overseas subsidiaries of domestic firms the difference between their hypothetical tax liability if they were to pay domestic taxes on their overseas business income and what they actually pay the foreign tax authority. (This provision is not a universal practice; French firms, for example, do not face this problem.[7]) As a result, a Japanese manufacturer conceivably could end up sending a check for its U.S. operations to the Internal Revenue Service comparable to the payment an American competitor sends but also have a financial obligation to Japan's National Tax Administration Agency. Unless offset by other advantages, the Japanese subsidiary would face a higher cost of capital than the U.S. firm.

A related argument applies to lenders that expand into overseas markets. Japanese banks that lend to American or Japanese firms subject to U.S. tax laws will not necessarily be able to lend to the companies on terms that

[7] For a discussion of this tax provision and other taxation issues involving multinational firms, see Joel Slemrod and Kenneth A. Timbers, "Japanese and U.S. Tax Treatment of their Resident Multinationals: Who Has the Competitive Advantage?" Paper prepared for the Princeton University-Japanese Ministry of Finance Conference on Comparative Tax Policy, Princeton University, April 2-3, 1990.

will give them the cost of capital enjoyed by firms in Japan. As indicated above, a significant portion of any capital cost advantage enjoyed by Japanese producers is a result of different tax policies in Japan; these advantages are not available to U.S. firms operating in the American market, even if they borrow from a Japanese bank. Therefore, one cannot assume, on the basis of lower capital costs in Japan, that Japanese banks are able to offer better terms on their lending in the United States than American banks.

Covered Versus Uncovered Interest Rate Parity - As noted above, nominal interest rates unquestionably are lower in Japan than in the United States and most other countries. Since this is true, why do investors with the ability to invest in the United States put any of their money into Japan? While some U.S. investments are risky, others, such as Treasury instruments, are very safe. To some experts the fact that nominal interest rates are unequal suggests market imperfections. According to this argument, even though taxes may drive a wedge between borrowing and lending costs -- so that Japanese capital costs could be lower than American ones -- at least a lender's rates of return should be equal across national boundaries if capital markets really are free. Therefore, given that nominal rates differ, capital movements are not free. If Japan's markets were liberalized, this argument concludes, U.S. firms would benefit from lower borrowing costs.

Of course, this argument makes an implicit assumption that the exchange rate does not vary. A Japanese investor would prefer a foreign investment with a relatively high interest rate to a local investment only if he can be sure that the movement between the yen and a foreign currency will not wipe out all of the advantage of the higher return available abroad. This condition, known as covered interest rate parity, suggests that overseas investment makes sense only if the interest rate advantage over a period of time is at least as great as the percentage difference between the current exchange rate and the forward exchange rate. In other words, the investor should be able to buy yen forward at a sufficiently low price to no more than offset the interest rate differential.

Until 1980 or so covered interest rate parity did not hold. Between 1976 and 1980, for example, covered market interest rates on short-term instruments in Japan generally exceeded those in the United States. American investors might have made a killing in Japan by investing in that country and buying forward exchange contracts to cover the possibility of the yen's depreciation. Since 1980 international capital markets have become much more closely linked. As several researchers have found, rejecting the hypothesis of covered interest parity has become increasingly difficult; in other words, exchange rate-adjusted interest rate differentials have narrowed dramatically.[8]

Marginal Versus Average Rates - Calculations of the cost of capital necessarily are based on past transactions but are used for making decisions about future projects. However, future transactions may not occur on the same terms. For example, a firm expanding rapidly may find that borrowing becomes more expensive the more it borrows, perhaps because the lender feels the borrower is overextending. In addition, a bank that relies on low-cost deposits for most of the funds that it lends also may find that some deposits are attracted only by means of much higher interest rates. In choosing a rate at which to lend for a new project, a rational bank would consider its cost to be the price of obtaining those incremental funds rather than the average cost of all its deposits. Hence, a low average cost of obtaining funds does not necessarily suggest much about the banking industry's willingness to lend at a comparably low rate.

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[8] Robert Alan Feldman, Japanese Financial Markets (Cambridge, Massachusetts: The MIT Press, 1986), pp. 182-83; Yoshio Suzuki, The Japanese Financial System (Oxford, England: Clarendon Press, 1987), p. 342; and K. Osugi, "Japan's Experience of Financial Deregulation Since 1984 In An International Perspective," BIS Economic Papers No. 26 (Basle, Switzerland: Bank for International Settlements, 1990), p. 59.

This argument has obvious relevance for comparisons of the cost of capital in the United States and Japan. The conventional explanation concerning the flow of savings into investment in Japan goes as follows: Tokyo sets unusually low interest rates on savings accounts. Japanese individuals nevertheless respond with high savings year after year. Corporations borrow from banks at comparably low rates, giving them an edge in international competition.

Whatever its relevance at one time for explaining Japanese interest rates and the cost of capital, this argument increasingly rings hollow in Japan. According to the Bank of Japan, 44.7 percent of commercial bank deposits earned deregulated interest rates as of March 31, 1989, up from a negligible percentage a few years earlier. As a result, while many individuals still are receiving below-market interest rates, banks necessarily have to use market-based interest rates in their lending decisions.

To see this conclusion, consider a bank's options. It has to pay a market rate of interest for the additional funds it will need. Were it able to pay a low, regulated rate on new deposits, it would have done so on all existing deposits and there would be no outstanding balance of deposits having unregulated rates.

In Japan most published rates of interest on savings are an average of market and nonmarket interest rates, even though only the former are relevant to the banking industry's decisions about new lending. In the United States, where interest rates are virtually all deregulated, average rates of interest approximate rates relevant to the decisionmaking process much more closely. Hence, a comparison of average rates showing lower charges for funds in Japan is misleading as a guide to the relative interest burdens facing firms in international competition. To solve this problem comparisons should focus on market-based interest rates in both countries.

This argument also applies to the international activities of Japanese banks. Financial firms, like nonfinancial concerns, almost always regard their international business as marginal to their domestic business. In other words, it is the last to be expanded (in the case of Japanese banks in the postwar period) and the first to be contracted (U.S. money center banks in the 1980s). For this reason Japanese banks surely will base the cost of funding their overseas lending out of Japanese deposits on the deregulated interest rates they have to pay their local depositors -- payments they could avoid if they were to eschew foreign lending. This, in turn, suggests that Japanese banks do not have nearly the advantage in lending in the United States that one would infer based on average interest rates paid in Japan. (To the considerable extent that Japanese banks fund their overseas lending with deposits collected abroad, the low interest rate advantage of Japanese banks further diminishes.)

Conclusion

Most studies conclude that Japanese firms have enjoyed a lower cost of capital than American companies, although the results are sensitive to exactly how costs are measured. They also are much less striking than one would estimate by looking at nominal interest rate differences alone. However, to the extent that capital costs in Japan are lower, many other alleged differences between American and Japanese management disappear. For example, Japanese firms often are accused of buying market share at the expense of profits. A more sophisticated variant of this argument suggests that Japanese competitors invest in market share as a means of obtaining higher profits down the road. Clearly, lower capital costs tend to increase the likelihood that a profit-maximizing firm would take this route. (However, some of the dimensions of capital cost, such as depreciation provisions, would not be relevant to an "investment" in market share, suggesting that a finding of lower capital costs is insufficient to determine that a firm is investing in market share.) Conversely, a short-term profit orientation, of which U.S. firms often are accused, could be a result of discounting long-term results more heavily due to higher costs of money. In other words, the studies summarized here suggest the possibility that capital costs, not management philosophies, may be the cause of what appears to be myopia on the part of U.S. firms.

The Bernheim-Shoven results, if they hold up under continued scrutiny, have another important implication for the competition between American and Japanese firms. By most of their measures, capital costs are quite close between American and Japanese firms for relatively riskless projects but far higher for U.S. firms in the case of risky investments. This suggests that Japanese firms have a comparative advantage in risky ventures and U.S. companies in relatively safe ones. If, as some experts believe, Japanese firms are able to reduce risk through group structures such as keiretsu, the comparative advantage of the two sides in the same projects would be even greater. Stretching this admittedly tenuous argument to the limit explains why Japanese firms have been willing to tackle markets that at one time seemed remarkably risky, such as the U.S. car market, but it also implies Japanese firms are unlikely to put funds into markets where they expect relatively risk-free, but low, returns. Such markets would be left to American firms that have a comparative advantage in low-risk projects.

Both the McCauley-Zimmer and the Bernheim-Shoven studies underline the sensitivity of the cost of capital to what investors in common stock would require to judge competitiveness with other investments they might make. By most measures the healthier the stock market, the lower the cost of capital. By this standard the cost of capital in Japan may have shot up dramatically in recent months as the Tokyo Stock Exchange has plummeted. Some analysts, most of them foreign, have suggested that the stock market in Japan could be in for a prolonged period of sluggish behavior lasting months or even years, regardless of what happens to the Japanese economy. If that is so, the cost of capital in Japan will not be nearly as attractive to Japanese companies as it has been during the prolonged bull market, which some analysts reckon lasted 25 years. This will be all the more true if interest rates on borrowed money and other debt remain close to the high levels they have reached in recent months.

As noted earlier, covered interest rate differentials between the United States and Japan largely disappeared during the 1980s. This implies an equalization of before-tax opportunities for investors. The beginning of the 1990s suggests the possibility that the United States and Japan may face an analogous convergence of capital costs, with possible implications for long-term management perspectives. Even if this convergence does not occur, Japanese firms increasingly will be at the mercy of foreign tax systems as they expand their operations overseas. For several reasons, then, the cost of capital may well have been an important past factor in explaining behavorial differences between Japanese and American firms, but it is likely to be far less important in the future.

For further information, contact Douglas Ostrom.

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The views expressed in this report are those of the author and do not necessarily represent those of the Japan Economic Institute.

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REPORT

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IN THIS ISSUE:

Keiretsu Questions Surface In Merger Announcement, SII Report 1

Tokyo Promises Changes In Land Policy In SII Report 3

Japanese Financial Market Update 5

Tokyo Edges Closer To China 8

Discussions Continue On Japan's Global Responsibilities 10

Tough Choices On New Super 301 Round 11

Notes: Japanese Defense Contractors 13

Keiretsu Questions Surface In Merger Announcement, SII Report

Cement companies are not normally headline grabbers. However, when one of Japan's four large cement and building materials concerns announced a merger with a leading nonferrous metals firm, the news received extensive press attention around the world. Apparently the reason stemmed from the identity of the two firms, Mitsubishi Mining and Cement Co., Ltd. and Mitsubishi Metal Corp. Both companies belong to the Mitsubishi presidents' club, a group of 29 corporate leaders who get together regularly to discuss common concerns. As such they are part of the inner circle of the Mitsubishi keiretsu, although not all bear the name Mitsubishi. (For details of the keiretsu structure, see JEI Report No. 2A, January 12, 1990.) In addition, the 29 firms are part of a larger group of companies that hold stock in each other, borrow most heavily from Mitsubishi Bank, Ltd. or other Mitsubishi-related financial institutions and have other historical and business linkages. By some counts, this broader group consists of hundreds, even thousands, of companies.

Sens. John Danforth (R, Mo.) and Robert Byrd (D, W.Va.), among other legislators, have told the White House in no uncertain terms that Japan must be named again in the upcoming Super 301 round. Secretary of Commerce Robert Mosbacher apparently backs this position, as do two of the nation's business organizations -- the Chamber of Commerce and the National Association of Manufacturers -- and a number of trade associations, including the Semiconductor Industry Association and the Automotive Parts & Accessories Association. Several influential members of Mr. Bush's cabinet, such as Secretary of State James Baker and Treasury Secretary Nicholas Brady, are said to understand that leaving Japan off this year's Super 301 list could trigger a protectionist backlash in the Congress. But they recognize, as apparently does the president, that citing Japan a second time could backfire in Tokyo. Japanese government, political and business leaders are tired of taking the blame for the huge bilateral trade imbalance and are fed up with Washington's nonstop pressure for trade concessions. Targeting Japan again also could undercut the still tenuous leadership position of Mr. Kaifu at the same time the White House is counting on him to shepherd the SII and the wood products talks to successful conclusions.

These pros and cons of putting Japan on the new Super 301 list have received considerable media attention. Virtually overlooked is the fact that there are no good product candidates for designation this year. The negotiations on supercomputers and satellites have succeeded because the problems raised by the United States are the result of Japanese government policies or programs. An agreement on wood products will be forthcoming for the same reason. But comparable targets are missing this time around.

Rice and the distribution system, seemingly the best possibilities in the Japan section of the 1990 National Trade Estimate Report (see JEI Report No. 14B, April 6, 1990), are out of the running. Washington and Tokyo have agreed to discuss Japan's near-total ban on rice imports within the context of the Uruguay Round of multilateral trade negotiations, while the Bush administration has shelved its demand for the repeal of the Large Retail Store Law until it can see whether the regulatory changes proposed by Tokyo in the SII talks work.

Japan's lack of copyright protection for American voice recordings made prior to 1978, cited by some analysts as another possibility, also is a nonstarter. If the administration decides to do something about this issue, it will be within the framework of the Special 301 provision of the 1988 trade act. Another prospect -- amorphous metals -- was scratched from the list April 18 when the U.S. government decided to pursue a complaint by Allied-Signal Inc. outside Super 301 or regular 301 channels. That leaves automotive parts and semiconductors as the leading candidates. But, as administration trade officials have acknowledged, the obstacles to expanded U.S. sales of these two product groups are an outgrowth of private-sector business practices.

Susan MacKnight

Notes

Japanese Defense Contractors - The Japan Defense Agency released a list April 6 of the top 10 Japanese companies to which it had awarded equipment contracts during FY 1989 (see Table). For the 25th consecutive year Mitsubishi

Heavy Industries, Ltd. was Japan's biggest defense contractor, winning contracts worth Y363.6 billion ($2.4 billion at Y150=$1.00) or 24 percent of the total. Notable among the awards MHI received was the one for design work on Japan's new fighter support aircraft. The Japanese industry giant is working with prime subcontractor General Dynamics Corp., whose F-16 serves as the model for the FSX. MHI also obtained contracts for a set of Patriot surface-to-air missiles, 11 F-15 fighter planes, a set of Type 88 surface-to-surface guided missiles, 12 SH-60J rescue helicopters and 56 Type-74 tanks.

The Y1.5 trillion ($10 billion) worth of equipment contracts JDA let in FY 1989 consisted of Y381.3 billion ($2.5 billion) for the Ground Self-Defense Force; Y512.6 billion ($3.4 billion) for the Maritime Self-Defense Force; Y506.4 billion ($3.4 billion) for the Air Self-Defense Force; Y98.3 billion ($655.3 million) for the Technical Research and Development Institute; and Y1.8 billion ($12 million) for other departments. The top 10 defense contractors won orders amounting to Y954.3 billion ($6.4 billion) or 64 percent of the total.

Top 10 Japanese Defense Contractors, FY 1989

(in billions of yen)

Rank	Company	Contracts	Percent Change From FY 1988
1.	Mitsubishi Heavy Industries, Ltd. (1)*	Y363.6	-0.2%
2.	Kawasaki Heavy Industries, Ltd. (2)	174.3	15.9
3.	Mitsubishi Electric Corp. (3)	111.7	10.8
4.	NEC Corp. (6)	71.0	-3.6
5.	Toshiba Corp. (4)	68.3	-18.0
6.	Ishikawajima-Harima Heavy Industries Co., Ltd. (5)	62.8	-18.9
7.	Nippon Seiko K.K. (7)	31.2	0.3
8.	Hitachi, Ltd. (--)	26.2	340.0
9.	Komatsu Ltd. (8)	23.6	0.0
10.	Fuji Heavy Industries, Ltd. (9)	21.6	-2.3

*Number in parenthesis indicates ranking in FY 1988.

Source: Japan Defense Agency

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JAPAN · ECONOMIC · INSTITUTE

JEI REPORT

A Two-Part Report: A and B

NO. 17A

April 27, 1990

JAPAN MOVES TO DEREGULATE TRUCKING INDUSTRY

Summary

Japan acted to deregulate the trucking industry last December, the first substantial revision affecting this freight transport mode since 1951. Both domestic and foreign shippers' needs for flexible and speedy delivery of cargo were going unmet under the old legislation, according to some analysts, who contended that too many regulations worked to restrict market entry and operating and pricing flexibility. The new laws, which possibly will go into effect in December 1990, will relax current regulations and enable motor carriers to provide integrated services combining air, rail, water and truck transport. Provided that deregulation is carried out according to the letter of the law, the once totally regulated Japanese trucking industry is likely to experience the same fierce competition that has characterized its American counterpart over the last 10 years. However, since the new legislation contains safeguards that allow the government to limit competition if it sees fit, Tokyo's perception of future transportation goals will determine how much regulatory freedom motor carriers really have.

Freight Transport Market

Domestic cargo traffic grew at a rapid annual rate of 8.4 percent in the 10 years preceding the first oil crisis in 1973. The oil crisis suddenly changed market conditions as well as the market itself. The economic slowdown of the mid-1970s trimmed freight traffic. That period also witnessed the first signs of a shift in the manufacturing sector from heavy industry to lighter high technology products. Freight volume rebounded in the late 1970s, but that

Japan Economic Institute 1000 Connecticut Avenue, N.W., Washington, D.C. 20036 202-296-5633

turnaround was cut short by the 1979 oil crisis and the 1980-82 economic slump. Even the return of moderate economic growth in 1983 did not stop the year-to-year drop in the amount of cargo handled. The freight transport market finally turned up in FY 1987, thanks to the start of what is now Japan's third-longest economic expansion of the postwar period. The following year a record volume of cargo was carried (see Table 1).

Table 1: Domestic Cargo by Mode of Transportation, FY 1970-FY 1988

(in millions of metric tons)

Fiscal Year	Truck	Water	Rail	Air	Total
1970	4,626	377	256	0.1	5,259
1975	4,393	452	184	0.2	5,030
1980	5,318	500	167	0.3	5,985
1981	5,231	479	152	0.4	5,861
1982	5,172	438	136	0.4	5,745
1983	5,123	438	121	0.4	5,683
1984	5,114	450	107	0.5	5,672
1985	5,048	452	99	0.5	5,600
1986	4,969	440	90	0.6	5,500
1987	5,046	462	83	0.7	5,592
1988	5,578	493	82	0.8	6,154

Source: Ministry of Transportation

The market shares held by the competing modes of freight transport were very stable in the 1980s except for the striking erosion of rail's share by trucking. This situation reflects the fact that motor carriers, water carriers and cargo airlines specialize in short, medium and long distances, respectively (see Table 2), limiting competition among them. Freight railroads, however, straddle the short- to medium-haul market. With construction of a nationwide highway system in the 1970s, trucking companies began to cut into the rail transport business. The privatization of the Japanese National Railway in April 1987 did not stop or reverse this trend because the main purpose of the JNR reform was to revitalize the passenger segment rather than freight transport.

Moreover, each mode of freight transport generally carries different types of cargo. Motor carriers transport food and fish products, textiles, consumer durables and nondurables and machinery. The main cargoes hauled by water are coal, cement and petroleum, while grains, chemicals and paper and pulp are moved by rail.

When freight traffic is presented on the basis of metric tons carried per kilometer rather than total volume hauled, the picture of a stagnating or a slow-growing motor carrier industry disappears. Table 3 indicates that the

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Table 2: Average Distance Covered by Freight Transport Mode, FY 1988

	(in kilometers)	
Truck	44.9	(24.9 miles)
Rail	285.1	(178.2 miles)
Water	431.3	(269.6 miles)
Air	906.6	(566.6 miles)

Source: Ministry of Transportation

Table 3: Truck Cargo, FY 1981-FY 1988

Fiscal Year	Volume (metric ton-kilometers)	Average Distance (kilometers)
1981	181.3	34.7
1982	188.7	36.3
1983	193.5	37.7
1984	200.8	39.3
1985	205.9	40.8
1986	216.1	43.5
1987	224.1	44.4
1988	243.8	44.9

Source: Ministry of Transportation

trucking business grew steadily from FY 1981 through FY 1986, with an average annual increase in weight per distance carried of 3.5 percent. This expansion stemmed from a rise in the average trip from 34.7 kilometers (about 21.5 miles) to 43.5 kilometers (about 27 miles), which worked out to a yearly gain of 4.6 percent. In FY 1988, moreover, the freight ton-kilometer figure for motor carriers jumped, thanks in large part to the boom in business investment and expanded public works spending.

In the opinion of Ministry of Transportation analysts the steadily rising ton-kilometer number in the 1980s reflected a watershed change in Japanese freight transport demand. By the latter part of the decade the movement of bulky, heavy materials from production sites to factories that predominated in the late 1960s and early 1970s had evolved to more shipments among factories and from factories to sales outlets (and from stores to homes) of increasing amounts of small, light products like semiconductors and appliances or small parcels in the 1980s. For example, the average lot of cargo carried by all modes of freight transport dropped from 3.8 metric tons per trip in 1980 to 2.63 metric tons in 1985, according to MOT. Small-scale, high-frequency and fast deliveries became the distinctive characteristics of freight transport in the 1980s in Japan.

Structure of Trucking Industry

The Road Transportation Law (Douro Unsou Hou) and the Railway Express Enterprise Law (Tsuun Jigyo Hou) regulate the trucking industry. These laws divide motor carrier services into three main groups: regularly scheduled route services, specific area services and services associated with freight shipped by rail. At the time of the laws' passage JNR dominated the Japanese freight transport market; trucking services connected with rail shipments, including loading and unloading cargo at the railroad station, were called tsuun. The Railway Express Enterprise Law enacted in 1949 was designed to ensure a stable volume of business and steady revenues for small tsuun operators. To this end such motor carrier services were exempted from the Antimonopoly Law; price competition was nonexistent.

In 1951 the Road Transportation Law was passed with similar goals in mind for a newly emerging trucking industry independent of the railroad. This law divides trucking services into those related to specific routes and those connected with customer areas. In the first category are motor carriers that serve specific routes on regular timetables and that load various types of freight from different shippers. The motor carriers in the second category serve only one customer on a consignment basis in a designated area, usually at the prefectural level; freight transport is limited to that area. Route-related services and area-designated services are not considered to be in competition with each other since the 1951 legislation contained a clear-cut division of labor.

The number of companies in each of these market segments has varied little (see Table 4) because market entry is limited by law. Big motor carriers, those that field more than 100 trucks, had a 17.3 percent share of the route-related business in FY 1989. Because firms providing this type of freight transport need nationwide networks, the number of competitors is relatively small (329 in FY 1989).

Table 4: Route and Area Trucking Companies, FY 1985 and FY 1989

Number of Route Trucking Companies	Number of Trucks				
	1-10	11-50	51-100	Over 101	Total
FY 1985	134	114	39	60	347
FY 1989	130	104	38	57	329

Number of Area Trucking Companies	Number of Trucks				
	1-10	11-50	51-100	Over 101	Total
FY 1985	18,126	15,947	1,123	378	35,574
FY 1989	16,886	19,075	1,843	588	38,392

Source: Ministry of Transportation

Large companies were particularly well-suited in the 1980s for a new route service called takuhaibin, which rapidly increased (see Table 5). Small packages, lighter than 30 kilograms (66 pounds), are collected at neighborhood stores, such as liquor outlets, rice vendors, mom-and-pop shops and convenience stores, by route trucking companies on a daily basis. Takuhaibin operators use a simplified pricing system and promise next-day delivery; that limits the competition to big motor carriers with their extensive networks.

Table 5: Small Package Delivery, FY 1981-FY 1987

(in millions)

Fiscal Year	Number
1981	107
1982	174
1983	278
1984	385
1985	493
1986	612
1987	762

Source: Ministry of Transportation

In contrast with the route-related market segment, a huge number of motor carriers transport cargo in designated areas. Companies with between 1 and 50 trucks have accounted for 90 percent-plus of this business in recent years. Firms providing this type of freight transport do not need a nationwide network or a large fleet of vehicles since they serve only one business customer on a consignment basis in a limited area.

Table 6: Trucking Linked to Rail Transport (Tsuun), FY 1980-FY 1988

Fiscal Year	Number of Companies	Freight Loaded and Unloaded (metric tons)	Number Of Sole Tsuun Operators
1980	359	176.1	9
1981	335	160.8	10
1982	314	146.3	5
1983	303	134.0	3
1984	280	120.4	6
1985	288	116.5	5
1986	252	107.9	3
1987	270	107.7	3
1988	293	112.9	3

Source: Ministry of Transportation

Tsuun (truck-rail service) could qualify as an endangered species since rail freight traffic has declined so sharply. For example, the volume of freight loaded and unloaded dropped from 176.1 million metric tons in FY 1980 to 112.9 million tons in FY 1988, and the number of companies exclusively providing tsuun decreased from nine to three (see Table 6). Therefore, companies in this line of business have tried to diversify and get licenses for other types of motor carrier services.

The Law and The Reality

The Road Transportation Law and the Railway Express Enterprise Law have common structures. Both regulate market entry and require approval of motor carriers' pricing policies and operating plans. When a company applies to enter the trucking business, Ministry of Transportation regulators evaluate market conditions. If they decide the newcomer could cause a serious mismatch between supply and demand, the application is turned down. But if a company does receive operating authority, it is protected from the stiff price competition that characterizes the American trucking business because tariff rates that "will probably cause unfair competition with other companies" are prohibited by law. This rule and those regulating operations are exempted from the Antimonopoly Law.

Despite the attempt to protect small motor carriers, historical and structural changes in the freight transport market have worked against that motive. Faced with rapidly declining demand, tsuun companies have had to diversify to survive. With the exception of three of the current operators all have multiple licenses. For example, Nippon Express Co., Ltd., originally a tsuun company, has become Japan's biggest integrated freight carrier, providing both route and area trucking services as well as air and water transport and overnight package delivery. Moreover, the Transportation Ministry actually has given licenses to some newcomers despite market conditions.

Nowadays many route motor carriers also are licensed to provide area services. Therefore, big trucking companies are double-listed in the route and the area service section of Table 4. But this expanded competition also has worked in reverse. Threatened by the entry of big route motor carriers into the market serving local businesses, trucking companies operating under an area-designated license have demanded the right to perform services that historically could only be provided by route operators, such as handling cargo from multiple shippers. In short, motor carriers are scrambling to compete with each other across the board.

In another case of practice differing from the law, although tariff rates must be approved by MOT, motor carriers legally can charge prices that are 10 percent over or under the approved rates. Because of growing competition in the trucking industry, actual freight transport prices are believed to be 10 to 20 percent below the officially approved rates. Gradually recognizing this reality, the Transportation Ministry recently admitted that its attempt at tight regulation of motor carriers is outdated.

Integrated Freight Transport

In any country freight forwarders play a critical intermediary role between shippers and carriers. In particular, shippers requiring multiple modes of transportation often turn to freight forwarders for help. These companies contract with whatever type of carrier is needed to move freight to its destination, and they assume responsibility for the delivery. The increase in international transportation has enhanced the importance of forwarders in integrating water/air, air/truck and water/truck transport. But in Japan the forwarding business is regulated by mode of transportation, making it sometimes difficult for forwarders for motor carriers, for example, to get a license to move freight by air or water. The Ministry of Transportation estimated the number of forwarders involved in trucking, water transport and air cargo as 14,977, 1,595 and 26, respectively, at the end of FY 1987.

The business community has complained about the regulatory treatment of freight forwarders. Keidanren (Japan Federation of Economic Organizations), a group representing the interests of big business, has pointed out the difficulties that forwarders face since they must obtain licenses for multiple modes of freight transport, each of which is regulated differently. Moreover, freight forwarders do not have the legal leeway to offer shippers a cost-saving package deal; the cost of integrated freight transport simply is the total of what each carrier charges for the service it provides. In late March 1988 Keidanren urged the government to overhaul the laws governing freight forwarding so that agents could provide lower-cost integrated service. The business organization also called for deregulation of the trucking industry.

Pressure for change also has come from foreign transportation companies, especially air cargo carriers and freight forwarders interested in doing business in Japan. In May 1985 Tokyo and Washington negotiated an interim air services agreement. Under that pact the U.S. government authorized Federal Express Corp. to begin small package express service to Japan. The start of FedEx operations in June 1988 introduced a new wrinkle to the Japanese freight transport market since the company not only handles transpacific shipments but also functions as a freight forwarder and delivers packages in Japan with its own fleet of vans. Worried that other foreign companies might follow FedEx, Japanese forwarders lobbied the government to deregulate their business to strengthen their competitive footing with potential overseas rivals.

These requests for deregulation from domestic and foreign businesses were debated by the Council on Transportation Policy, an advisory group to the minister of transportation, and the Provisional Council for the Promotion of Administrative Reform, an advisory group to the prime minister. Both councils considered how to deregulate Japan's freight transport market and reorganize the industry.

The New Rules

In March 1989 the Ministry of Transportation submitted to the Diet its proposal for two new laws. Passed in mid-December 1989 were the Freight Transportation by Motor Vehicle Law, which governs the trucking industry, and the General Freight Forwarding Law. The main points of the first law are as follows:

- The division between route and area trucking services has been eliminated. By permitting combined operations, the numerous motor carriers that have provided area trucking services in the past now will be able to load freight from multiple shippers.

- The licensing system regulating market entry based on supply and demand conditions has been scrapped, replaced by a permit system. To receive operating authority a motor carrier only must prove it is qualified to provide capable, safe service.

- The legislation contains a safeguard clause to cover periods of "excess competition." During those periods the minister of transportation has the right to suspend for a limited time the issuance of permits to newcomers, even if they are regarded as qualified.

- Significant changes in motor carriers' operating plans still will have to be approved by MOT regulators, although some minor modifications are exempt, like a change in the number of vehicles operated by a trucking company. These minor changes can be handled simply by notifying the ministry.

- Tariff rates no longer will require prior approval. Instead, motor carriers can notify the government of the prices they plan to charge shippers. If MOT determines that the rates are not fair, it can order trucking companies to change their prices within a limited time.

The law regulating freight forwarding addresses:

- Replacement of the licensing system for freight forwarders with a permit system, much like the revision for motor carriers; however, this law does not have a safeguard clause. The requirement that market entry be regulated according to supply and demand is repealed for air cargo forwarders and tsuun operators.

- Pricing, which will work on a notification system prior to an operation's start-up; MOT has the authority to require an agent to change prices if it feels they reflect unfair competition.

- Abolition of the Railway Express Enterprise Law.

The Ministry of Transportation is expected to take a long time to issue implementing regulations and rules as well as guidelines since these changes are the first since the Railway Express Enterprise Law was enacted in 1949 and the Road Transportation Law put in effect in 1951. Implementation may begin this December.

Conclusion

Keidanren commented in mid-July 1989, prior to the enactment of the new legislation, that it appreciated the proposed laws from the standpoint of deregulation and revitalization of the transportation industry. At the same time the business group expressed concern about the safeguard provision in the new trucking law and about MOT's authority to veto tariff rates and prices, saying these powers could distort the deregulation process if they are handled improperly by regulators.

Other unanswered questions also make judgment premature over whether the new laws promise real progress or not. For example, the freight forwarding legislation does not address the issue of integrated service. It still is unclear how integrated service, a top priority of shippers and forwarders alike, will be provided in the future. Another concern is whether the potential for increased competition by domestic as well as foreign freight transporters will streamline part of Japan's distribution system, a matter of concern at home and abroad. Concerns such as these lead many analysts to say that the two new laws are a first step in the right direction. Whether this will be a big step or a small one depends on Ministry of Transportation regulators.

For further information, contact Hideo Takahashi.

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REPORT

A Two-Part Report: A and B

NO. 17B
April 27, 1990

IN THIS ISSUE:

Japan's Trade Surplus Declines Sharply 1

Consumption Tax Frustrates Budget Process 5

A Japanese Call For Structural Reform 6

Antitrust Action Heats Up 8

Pentagon Outlines Future Asian Pacific Defense Strategy 9

Japan Combines Cautious Action With Long-Term Environmental Plan 14

Notes: 767-X Project;
Amorphous Metals 16

Japan's Trade Surplus Declines Sharply

Order the champagne or cancel the party? Potential celebrants in Tokyo and Washington could have been forgiven if they appeared a little confused by the omens presented by Japan's trade data during the early spring. The most widely cited statistic, the overall surplus on a dollar-denominated customs-clearance basis, declined 27.2 percent between 1989's first quarter and the January-March period (see Tables). Even the bilateral imbalance with the United States, which has proven more stubborn than the overall surplus, dropped 19.7 percent to the lowest quarterly figure in five years. In light of American and Japanese hopes that both the aggregate and the bilateral surpluses would contract, the figures would appear to suggest continuing improvement.

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But a closer look reveals numerous problems that illustrate the difficulty of evaluating the numbers either positively or negatively. In January, for example, Japan's overall surplus practically vanished, falling to a mere $337.8 million. While relatively smaller surpluses or even deficits historically have been registered in January, this year's figure was down an incredible 89.6 percent from January 1989, when the surplus had been partly inflated by a number of temporary factors. Had Japan's trade surplus, which heretofore had been considered virtually inevitable, suddenly disappeared? Some American analysts, coming to such a conclusion, somewhat incredibly argued that such a small surplus undermined economic stability in Japan; they suggested that a slower decline would help stabilize Tokyo's stock market, then in rapid retreat. Since these same analysts tied the fate of the stock exchanges in Tokyo and New York together, they reasoned that Americans had cause to be concerned about Japan's disappearing trade surplus.

Other analysts on both sides of the Pacific pointed out the fallacy of such thinking. For starters, the stock market decline was a result of other factors, not the trade figures (see JEI Report No. 13B, March 30, 1990). Second, the declining yen -- which was linked to the stock market turmoil -- suggested that Japan's trade surplus soon could turn up again. Finally, these analysts noted, one month's figures easily could be an aberration.

The danger of drawing conclusions from one month of data was demonstrated after the release of the February and the March figures, the first of which showed a sizable drop in the overall dollar-denominated surplus on a year-to-year basis and the second a small increase. Taken together, the three sets of monthly numbers suggest very interesting developments in Japan's external sector. For example, despite the yen's relative weakness for almost the past 18 months, the volume of imports continues to show considerable growth. In the January-March quarter price-adjusted imports were running 6.7 percent ahead of a year earlier, despite sluggish growth in industrial production and in consumer spending. Similarly, export volume was up a mere 2.6 percent. Both figures suggest that the yen's near doubling in value since September 1985, a process virtually complete by early 1988, is casting a very long shadow and still may be offsetting the 20 percent or so depreciation in the currency since its all-time monthly high in November 1988.

The future of Japan's trade surplus will be determined in part by the relative effects of the yen's appreciation from 1985 to 1988 and the depreciation since then. In addition, these exchange rate factors will compete for influence with the effects of rising income levels in Japan and in that country's overseas markets, including the United States. The Japanese economy could falter badly should the weakness in the Tokyo stock market persist and interest rates remain high or rise further. Sluggish economic expansion, in conjunction with a weak yen that increasingly overpowers the effects of the currency's earlier rise in value, could suppress the growth of imports and increase both the overall trade surplus and the imbalance with the United States. In short, the news on the trade front in the first three months of 1990 was good, but continued progress is not guaranteed.

Douglas Ostrom

Japan's Total Trade in Dollar Terms

(in millions of dollars)

	Exports (f.o.b.)	Change Over Year-Earlier Period	Imports (c.i.f.)	Change Over Year-Earlier Period	Trade Balance
1985	$175,638	3.2%	$129,539	-5.1%	$46,099
1986	209,151	19.1	126,408	-2.4	82,743
1987	229,221	9.6	149,515	18.3	79,706
1988	264,917	15.6	187,354	25.3	77,563
1989	275,175	3.9	210,847	12.5	64,328
1988: I	60,279	17.1	44,505	39.2	15,774
II	65,179	14.5	47,260	29.9	17,919
III	67,169	16.1	47,258	23.2	19,911
IV	72,291	14.8	48,331	12.9	23,960
1989: I	68,227	13.2	51,142	14.9	17,085
II	67,602	3.7	51,292	8.5	16,310
III	69,595	3.6	53,048	12.3	16,547
IV	69,751	-3.5	55,364	14.6	14,387
1990: I (p)	66,689	-2.3	54,253	6.1	12,436

Japan's Total Trade in Yen Terms

(in billions of yen)

	Exports (f.o.b.)	Change Over Year-Earlier Period	Imports (c.i.f.)	Change Over Year-Earlier Period	Trade Balance
1985	Y41,956	4.0%	Y31,085	-3.8%	Y10,871
1986	35,290	-15.9	21,551	-30.7	13,739
1987	33,315	-5.6	21,737	0.9	11,578
1988	33,939	1.9	24,006	10.4	9,933
1989	37,823	11.4	28,979	20.7	8,844
1988: I	7,713	-3.1	5,688	14.7	2,025
II	8,163	0.1	5,918	13.6	2,246
III	8,924	4.9	6,280	11.3	2,644
IV	9,139	5.1	6,121	3.3	3,018
1989: I	8,705	12.9	6,516	14.6	2,189
II	9,222	13.0	6,997	18.2	2,225
III	9,911	11.0	7,547	20.2	2,363
IV	9,985	9.3	7,919	29.4	2,067
1990: I (p)	9,763	12.2	7,922	21.6	1,841

Japan's Trade with the United States in Dollar Terms

(in millions of dollars)

	Exports (f.o.b.)	Change Over Year-Earlier Period	Imports (c.i.f.)	Change Over Year-Earlier Period	Trade Balance
1985	$65,278	8.9%	$25,793	-4.0%	$39,485
1986	80,456	23.3	29,054	12.6	51,401
1987	83,580	3.9	31,491	8.4	52,090
1988	89,634	7.2	42,037	33.5	47,597
1989	93,189	4.0	48,246	14.8	44,943
1988: I	19,859	10.3	10,090	44.4	9,769
II	21,610	2.0	10,458	37.8	11,152
III	23,056	6.6	10,667	29.3	12,389
IV	25,109	10.3	10,821	25.0	14,288
1989: I	22,726	14.4	11,599	15.0	11,127
II	22,997	6.4	12,064	15.4	10,933
III	24,117	4.6	12,462	16.8	11,655
IV	23,347	-7.0	12,120	12.0	11,227
1990: I (p)	21,640	-4.8	12,709	9.6	8,931

Japan's Trade with the United States in Yen Terms

(in billions of yen)

	Exports (f.o.b.)	Change Over Year-Earlier Period	Imports (c.i.f.)	Change Over Year-Earlier Period	Trade Balance
1985	Y15,583	9.6%	Y6,213	-2.4%	Y9,369
1986	13,564	-13.0	4,918	-20.9	8,646
1987	12,148	-10.4	4,582	-6.8	7,566
1988	11,487	-5.4	5,388	17.6	6,099
1989	12,816	11.6	6,632	23.1	6,184
1988: I	2,541	-8.8	1,290	19.1	1,251
II	2,706	-10.8	1,309	20.5	1,397
III	3,063	-3.6	1,418	16.7	1,645
IV	3,177	0.9	1,371	14.4	1,806
1989: I	2,899	14.1	1,478	14.6	1,421
II	3,139	16.0	1,648	25.9	1,491
III	3,436	12.2	1,773	25.0	1,663
IV	3,342	5.2	1,733	26.4	1,609
1990: I (p)	3,168	9.3	1,856	25.6	1,312

to the earlier standard regarding exporters, which was little used. Justice expects to make a decision by fall. Depending on the scope of its finding, new legislation may be required.

In addition to these broad measures that have domestic and international implications, two recent antitrust actions focus more narrowly on bilateral issues. American businessman T. Boone Pickens appears to have opened another front in his continuing battle with Koito Manufacturing Co., Ltd., an automotive parts supplier usually identified as part of the Toyota Motor Corp. group. On April 10 his spokesman revealed that Mr. Pickens had filed with Japan's FTC a complaint claiming that Japanese automakers had forced parts companies, such as Koito, to supply products at unfairly low prices. As the largest stockholder in Koito, Mr. Pickens presumably would like to see a higher price for such parts, in possible contrast to Koito's second-largest stockholder, Toyota. Mr. Pickens claims to have letters from 50 Japanese auto parts makers charging that their customers have beaten down prices.

In a related development, both Mr. Pickens' spokesman and Capitol Hill sources revealed in mid-April that two congressional committees have requested the Federal Trade Commission to look into Japanese corporate groups centered around Japanese automakers with the objective of ascertaining whether U.S. antitrust laws have been violated. Presumably, the congressmen feel that the ties between Japan's motor vehicle manufacturers and their parts suppliers unfairly hinder free competition between American and Japanese parts producers. The FTC shares responsibility with the Justice Department for the enforcement of American antitrust statutes. Rep. Jack Brooks (D, Texas) and Sen. Ernest Hollings (D, S.C.), chairmen of the House Judiciary Committee and the Senate Commerce, Science and Transportation Committee, respectively, in late March reportedly requested the investigation, which began in early April. The congressmen asked that the findings be ready by mid-June.

These actions taken together indicate new attention to a sometimes neglected dimension of antitrust activity: extraterritorial enforcement. As such, they raise questions of conflicting laws and policies across national boundaries. While Japan often is the current focus, many of the same issues are potentially contentious between the United States, which arguably has the strongest antitrust laws, and European countries, which share what many feel is Tokyo's ambivalent attitude toward antitrust. With economic restructuring in Europe resulting from both the evolution of Eastern Europe's economy and the impending integration of the European Community, these issues eventually may have transatlantic as well as transpacific implications. In response to the emerging problem of international antitrust coordination, Professor Mitsuo Matsushita of Tokyo University already has nominated antitrust for a place on the agenda of the next round of multilateral trade negotiations under the General Agreement on Tariffs and Trade. Since the current GATT round, which began in 1986, has at least half a year to run, this suggestion, if accepted and if GATT remains a viable force, could put antitrust at the forefront of issues for years to come.

Douglas Ostrom

Pentagon Outlines Future Asian Pacific Defense Strategy

A Department of Defense official warned in testimony April 19 before the Senate Armed Services Committee that abrupt and major changes in the U.S.

security presence in the Asian Pacific would lead to regional instability. Paul Wolfowitz, under secretary of defense for policy, told legislators that whether or not the Soviets have reduced their threat in the region, the U.S. forward presence there will "remain critical to deterring war, supporting our regional and bilateral objectives and performing our military missions." The volatility and uniqueness of the East Asian environment means that America's deployment patterns should remain much as they are, particularly since they now are near the levels needed to sustain a commitment in the area, Mr. Wolfowitz emphasized.

Responding to a reporting requirement in the FY 1990-FY 1991 Defense Authorization Act, the official presented DOD's Strategic Framework for the Asian Pacific Rim: Looking Toward the 21st Century. This report discusses specific ways America's Asian allies can contribute more to regional stability as well as how the United States can reduce and restructure its military presence in the Asian Pacific. There is a growing perception on Capitol Hill that the U.S. defense budget should continue to be slashed given an apparent diminution in the Soviet threat and overall fiscal pressures.

However, a major thrust of Mr. Wolfowitz's testimony was that the Asian Pacific is not Europe; defense cutbacks that might be appropriate for the European arena, given Moscow's weapons and force reductions and the nascent political reform movement in Eastern Europe, are not analogous to East Asia's situation (see Table 1). Political volatility and turbulence will characterize important regional players, such as China, the Soviet Union, North Korea, Cambodia and the Philippines, he pointed out. Moreover, while the Soviet Union has been withdrawing some aircraft and ships from Southeast Asia, Moscow continues to modernize its weapons systems. In the Soviet Far East military district that fronts Japan, in particular, Soviet capabilities still appear "to far exceed those needed for defense," ensuring a continued threat to U.S. and allied interests in Northeast Asia, Mr. Wolfowitz stated (see Table 2).

Table 1: U.S. Forward-Deployed Forces

Command	Total Personnel	Forward Deployed	Percent of Total Force[1]
Europe	341,000	341,000[2]	16.0%
Pacific	362,000	135,000[3]	6.3
Other Noncontinental U.S. Commands	34,000	34,000[4]	1.6

[1] Total force is 2.13 million.
[2] This number includes 21,000 personnel afloat.
[3] This number includes 25,000 personnel afloat but does not include 8,000 personnel assigned to Guam.
[4] This number includes 12,000 deployed to Africa and Near East/South Asia; 21,500 deployed to the Western Hemisphere; and 500 stationed in the Soviet Union, Eastern Europe and Antarctica.

Source: Department of Defense

While urging a continued, substantial air and naval presence in the Asian Pacific, the Pentagon nevertheless is acutely aware of budgetary realities. DOD therefore has proposed measured reductions of some ground and air forces in South Korea, Japan and the Philippines, reductions that it believes will not destabilize the region. The Pentagon's 10-year, phased-in plan would decrease troop strength by 14,000 to 15,000 service personnel (out of the total 135,000 deployed in the Asian Pacific) during the first three years. The next three to five years would see proportionally greater reductions in combat forces undertaken incrementally to "ensure that potential adversaries do not misread our deterrent capability and intentions." Modest cuts beyond the second phase of reductions would continue during the remaining years, given then existing circumstances. The phased approach would allow the United States to remain flexible and responsive to changes in regional conditions, Mr. Wolfowitz stated.

Table 2: Soviet Forces in Asia

Ground Forces	
Maneuver Divisions	48
Artillery Divisions	3
Tanks	11,500
Artillery	12,500
Helicopters	1,100
Pacific Fleet	
Total Ships, Vessels and Craft	875
Ballistic Missile Submarines*	26
Attack Submarines	94
Carriers	2
Cruisers	11
Destroyers	8
Frigates	56
Minor Combatants	202
Amphibious	21
Support and Miscellaneous Craft	455
Combat Aircraft and Helicopters	345
Naval Infantry Divisions	1
Air Forces	
Bombers	215
Fighters/Attack Aircraft	890
Air Defense Fighters	590

*This is a combined total for conventionally powered and nuclear-powered ballistic missile submarines.

Source: Department of Defense

Another key theme in the Pentagon's report concerns the critical importance of the U.S.-Japan relationship, described as the "linchpin of the U.S.-Asian security strategy." DOD stresses that it is in the U.S. interest to maintain a forward-deployed presence in Japan over the long term because of the strategic location of bases and the cost effectiveness of the U.S. presence there compared to elsewhere. However, Pentagon strategists recognize that over the next decade U.S.-Japan relations most likely will continue to be strained by trade disputes and fears over the loss of American technological competitiveness. In addition, the merits of the U.S.-Japan security relationship no doubt will continue to come under fire by some Japanese who favor either a more neutral posture or, conversely, a more nationalistic approach to defense. Outraged by the persistent U.S. trade deficit with Japan, a growing number of American legislators also no doubt will call for a cutback in the U.S. presence -- and military dollars spent -- in Japan unless Tokyo shoulders far more of the mutual defense burden.

Thus, DOD believes that the following elements should guide American defense policymaking toward Japan:

- The U.S. force level should be reduced as much as possible while maintaining essential bases that enable this country to help provide regional stability and deterrence in Northeast Asia.

- The United States should continue to encourage Japan to increase its territorial defense capabilities and enhance its ability to defend its sea lanes out to 1,000 nautical miles, while at the same time discouraging the development of an expanded reach that would threaten its neighbors rather than help maintain stability.

- Japan should be urged to participate more closely in political efforts with Western allies to maintain stability in key regions of the world as well as encouraged to support Asian Pacific adjustments.

- Tokyo should be encouraged to increase its financial support for U.S. forces operating in Japan.

- Maximum procurement from the United States should be advocated to maintain interoperability of military systems.

- Increased technology flowback should be pressed, while Japanese development of noncomplementary systems should be discouraged.

- The bilateral security consultative process should be revitalized.

DOD's proposed multiphase reductions for the Asian Pacific region notwithstanding, the United States would continue to have substantial air and naval capabilities in Japan while possibly trimming ground and some support air forces, particularly in Okinawa; approximately 5,000 to 6,000 personnel stationed in Japan would be withdrawn during the first three years. Current deployment patterns on mainland Japan would be little changed; the U.S. Air Force presence would be maintained at Misawa and a forward-deployed carrier would be kept at Yokosuka (see Table 3). DOD also plans to make adjustments to U.S. bases and facilities at Okinawa with the aim of returning property to improve civilian-military relations.

In the second cutback phase the Japan Self-Defense Forces would be encouraged to improve qualitatively through procurement of advanced weapons systems and streamlined infrastructure for command, control and logistics. The

Table 3: U.S. Troops Deployed in Japan

Bases

Main Islands

- Yokota (Headquarters, U.S. Forces Japan; Headquarters, Fifth Air Force)
- Zama (Headquarters, U.S. Army IX Corps)
- Yokosuka (Headquarters, U.S. Naval Forces Japan)
- Sasebo (Naval fleet base)
- Atsugi (Naval air station)
- Iwakuni (Marine Corps air station)
- Misawa (Air base; naval air unit)

Okinawa

- Kadena (Air base; naval air unit)
- Camp Courtney (Marine Corps camp)
- Futenma (Marine Corps air station)

Troop Strength

Army	2,400
Navy	6,850
Air Force	16,200
Marine Corps	24,700
Total	50,150

Source: Department of Defense

United States also plans to pursue further reductions in the Asian Pacific contingent on regional stability and its allies assuming more responsibilities.

The final period could see still further reductions in U.S. forces stationed in Japan. However, the Pentagon believes that no matter how stable the region or sophisticated the Japanese self-defense capability, the United States must maintain "deterrent capabilities" in Japan, such as a home-port aircraft carrier, strategic lift aircraft and an air force capability to carry out surgical strikes.

In the area of cost sharing Mr. Wolfowitz stated up-front that Washington expects increased assistance from all its allies, not just Japan. But he warned Congress to avoid the temptation of decreeing a certain level of gross national product or other specific criteria as constituting a "fair share" of the defense burden. "Arithmetic formulas for increases based solely on the premise that there are significant trade imbalances or simply that a specific ally should 'do more because it has the money' will likely be met with stiff resistance because such approaches can be viewed as challenges to national sovereignty," the DOD report states. Congress last year passed legislation that requires the administration to negotiate with Tokyo to achieve Japanese security contributions equal to 100 percent of the direct costs of maintaining the

U.S. forces based on the island nation (see JEI Report No. 38A, October 6, 1989). In the past legislators also have proposed that Japan be required to spend 3 percent of its GNP on defense (see JEI Report No. 19A, May 13, 1988).

Barbara Wanner

Japan Combines Cautious Action With Long-Term Environmental Plan

An April 17-18 global environmental conference in Washington blended environmental and economic concerns, but the mix proved volatile, initially igniting criticism from many of the European participants, who urged more action rather than more study. Left out of most reports about the 17-nation conference, which attempted to achieve more serious consideration of the economic impacts of dealing with global climate change, were measures described by the Japanese delegation, led by Environment Agency director general Ishimatsu Kitagawa.

Although the Japanese voiced lofty goals, such as a 100-year plan to reduce carbon dioxide emissions, other policy statements appeared to echo the American theme of more study, which may have been why the U.S. media appeared to overlook Japan's presence. For example, a position paper available at the conference included a statement from June 1989 by the Ministers for Global Environmental Conservation, a group of 19 high-level Japanese officials. "It is vital to strive for the protection of the global environment, while assuring the stable development of the world economy . . .," the outline read. The chumminess of the Bush administration with the Japanese on this issue surfaced in Environmental Protection Agency administrator William K. Reilly's speech, which singled out the Japanese for their "ambitious and imaginative commitments" to address global warming through research and development of new technologies over the next 100 years.

The 100-year plan, developed by the Ministry of International Trade and Industry, accepts the idea that levels of carbon dioxide are mounting worldwide. Scientists generally do not dispute this but rather disagree over whether this increase will result in the warming of the earth's atmosphere, which could affect weather patterns and coastlines and bring about a variety of other potentially hazardous consequences. Since proposals to cut down CO_2 invariably address industrial and automotive emissions of the gas, the economic impact of a cutback could be staggering.

Some estimates put the cost to the U.S. economy of a 20 percent reduction in CO_2 emissions at $800 billion to $3.6 trillion over 100 years, depending on how much technology and clean alternative energy is used. Souzaburo Okamatsu, director general of MITI's industrial location and environmental protection bureau, summarized a Japanese study at the White House conference that said a cutback of 20 percent in CO_2 emissions over the next 10 years could result in a 0.4 percentage point decline in the worldwide gross national product rather than an initially projected gain of 1.5 points. Just a freeze on carbon dioxide emissions at 1989 levels could result in world economic stagnation, he warned, adding that most of the impact would be felt by developing nations. MITI's plan basically aims at stabilizing Japan's CO_2 emissions in the next 50 years and gradually phasing them out before 2090.

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IN THIS ISSUE:

Uruguay Round Heads Into The Final Stretch 1

Japan Expanding Middle East Role 3

Environment Fund Proposed
To Asian Development Bank 6

Electoral Reforms Proposed In Japan 8

New Bill Addresses Improved Collection
Of Foreign Investment Data 10

Japan Dropped From Super 301 List 12

JEI Personnel Changes 13

Notes: Audio Recording Copyright;
Foreign Brokers In Banking 14

Uruguay Round Heads Into The Final Stretch

When the current round of multilateral trade negotiations under the General Agreement on Tariffs and Trade was launched in late 1986, participants from the United States and Japan had high hopes that the negotiations would produce a set of agreements that would lead to mutually beneficial increases in international trade. While the agenda of the Uruguay Round, named for the country where the talks were initiated, ambitiously encompasses 15 occasionally overlapping sectors, the four-year timetable established at the time seemed, to the uninitiated, more than generous. (For details of the Uruguay Round, see JEI Report No. 25A, June 30, 1989). Now, as the final countdown begins, the goal still is to conclude negotiations by this December, but the timetable is beginning to look inadequate even though various framework agreements have been time. However, a difference may have emerged recently with respect to strategy. Japanese press reports indicate that the United States and the European Community have offered a joint proposal that, in effect, would lead to the use of a Super 301-type negotiating mechanism against countries that fail to open their markets to foreign-generated services. Tokyo reportedly has reacted negatively to this idea, apparently feeling that the disadvantages stemming from unilateral action as called for under Super 301 outweigh the potential benefits of freer trade in services.

Tokyo also is concerned about the lack of enforcement mechanisms in GATT. In that connection International Trade and Industry Minister Kabun Muto responded enthusiastically in an interview published April 29 in Nihon Keizai Shimbun, the economic daily, to an idea that Ms. Hills had appeared to endorse in an April 16 speech in Dallas, Texas. The proposal, which had been submitted by Canada to Mr. Dunkel a few days earlier, calls for a new body called the World Trade Organization that would have significant powers and be modeled after the International Monetary Fund and other international organizations. (GATT is a series of contractual agreements among the parties but it does not have legal status as an international body.) Mr. Muto called for movement toward the establishment of such an organization by the end of the year. USTR sources indicate that discussion of the proposal should follow the completion of the Uruguay Round. In the past Japan and other countries have complained that Washington has a spotty record of complying with GATT rulings that go against the United States.

In short, as the current MTN talks enter their final months little visible progress is evident, and a number of participants are beginning to express their frustrations publicly. However, to some observers who have noted a lack of interest in the Uruguay Round among the American public and Congress, even the public venting of frustrations is part of the negotiating process. By raising the issue of the implications of failure -- as Ms. Hills did in her Dallas speech -- advocates of the current round hope to increase public pressure in the United States and elsewhere for a successful outcome.

These same observers note that every country has an incentive to cling to a bargaining position as long as possible in the hopes of getting the best possible deal, making progress appear minimal or nonexistent. By this line of reasoning, the Uruguay Round negotiations are almost inevitably an exercise in brinkmanship. In addition, a looming deadline for Washington is the May 1991 expiration of existing "fast-track" negotiating authority that would permit expedited congressional consideration of a new MTN agreement. For its part Tokyo faces the prospect of a renewed emphasis in Washington on bilateral negotiations should the Uruguay Round fail. Both countries share with other GATT participants the danger that the multinational trading regime could be at risk should success in Geneva prove elusive in the next eight months.

Douglas Ostrom

Japan Expanding Middle East Role

Tokyo gradually is increasing its diplomatic activities in the Middle East, signaling a shifting balance between economic and foreign policy priorities in the region. Even though military power remains a key factor in relations among Middle Eastern countries, Japan is finding that its economic strength gives it growing influence in the region. Among the indications of Tokyo's new position in the international hierarchy are its reported role in facilitating the exchange of views between the United States and Iran and its willingness to become more deeply involved in Israeli-Palestinian issues.

Japan's total 1989 trade with the Middle East and North Africa grew 8.9 percent in dollar terms, from $28.6 billion to $31.1 billion; in the process its regional trade deficit worsened, increasing from $10.4 billion to $14.7 billion (see Table 1). Changes in Japan's trade with nonoil-producing states was uneven, showing some good gains (with Sudan, for example) and some contractions (with Libya and Syria, in particular). The total amount of trade with both Israel and Egypt fell slightly in 1989, although the trade imbalances with these two countries moved in opposite directions. Trade with oil-producing states was up almost across the board, a combination of greater imports of petroleum (see Table 2), higher dollar prices for oil ($16.71 a barrel in 1989 versus $15.60 in 1988) and a weakening yen/dollar exchange rate (Y138.00=$1.00 in 1989 versus Y128.15=$1.00 in 1988).

Table 1: Japan's Trade with the Middle East and North Africa, 1988-89

(in millions of dollars; exports f.o.b., imports c.i.f.)

	1988		1989	
Trading Partner	Exports	Imports	Exports	Imports
Bahrain	$119.4	$307.9	$143.5	$342.2
Egypt	481.6	234.2	472.0	118.9
Ethiopia	65.4	57.8	54.8	55.1
Iran	807.8	1,164.2	922.4	1,792.3
Iraq	406.0	828.5	490.7	1,214.5
Israel	420.4	684.5	317.5	757.9
Jordan	140.1	34.3	66.6	23.5
Kuwait	730.5	1,590.4	670.8	2,338.9
Lebanon	77.7	3.2	71.0	6.2
Libya	601.9	5.6	193.3	0.6
Oman	348.2	1,689.7	334.3	1,530.3
Qatar	172.5	1,139.1	211.2	1,546.0
Saudi Arabia	3,142.2	6,348.2	2,763.2	7,048.3
Sudan	71.4	59.7	97.0	84.7
Syria	204.9	6.9	76.2	4.3
United Arab Emirates	1,286.1	5,323.6	1,296.2	6,051.4
Total	9,076.1	19,477.8	8,180.7	22,915.1

Source: Japan Tariff Association

Japan's ties with Iran are benefiting from the de facto end of the Iran-Iraq war. A major benefit is the amicable settlement of Iranian claims related to the dissolution of a joint effort to rebuild a giant petrochemical plant. Begun over 16 years ago the Bandar Khomeini facility was attacked repeatedly by Iraq, leading the Japanese construction consortium heading the project to pull out even though the plant was nearly complete. The February 8 final disposition

Table 2: Japan's Imports of Crude Oil by Country, 1988-89

(in thousands of kiloliters)

Supplier	1988	1989
United Arab Emirates	37,814	42,770
Saudi Arabia	27,942	27,391
Indonesia	26,347	26,552
Iran	10,970	16,991
China	15,673	14,483
Oman	17,098	14,783
Iraq	9,966	12,578
Qatar	10,255	12,359
Gulf Neutral Zone	8,200	11,559
Kuwait	8,124	9,670
Mexico	10,178	9,613
Malaysia	4,638	4,735
Brunei	2,696	2,064
Other	3,950	4,143
Total	193,851	209,691

Source: Petroleum Association of Japan

of Iran's claims with a payment of approximately Y130 billion ($866.7 million at Y150=$1.00) opened the way for a private investment mission and official talks with Teheran in March on increasing Japanese foreign aid. The investment mission sponsored by Keidanren (Japan Federation of Economic Organizations) brought vice presidents and senior managers from over 20 Japanese companies to Iran -- the first such mission in nearly 20 years. The Ministry of Foreign Affairs reported progress on extending technical assistance in agriculture and joint oil exploration projects. Talks stalled, however, over a plan to construct a new airport.

Tokyo's willingness to help Iran rebuild its war-torn economy has apparently paid off in the diplomatic arena. Former Ambassador to Jordan Makoto Watanabe, who now heads the Mideast and African affairs division within the Foreign Ministry, reportedly has been a channel for the exchange of views between Washington and Teheran. While Mr. Watanabe denies any role in discussions about the American hostages held by pro-Iranian groups in Lebanon, his efforts to improve overall U.S.-Iran ties at least have helped build some level of trust between the two antagonists. Tokyo's willingness to serve as more than just a communications conduit has received praise from the State Department and generated U.S. expectations of greater Japanese initiatives in areas not directly related to commercial interests.

One such area is the complex question of Palestinian-Israeli relations. Since 1988 Tokyo has made overtures directly to both Israel and the Palestine Liberation Organization. A November 1989 meeting between Israeli and Japanese foreign ministers produced an agreement to establish a consultation mechanism on Mideast issues, a much more sound arrangement than the infrequent official visits of the past (see JEI Report No. 45B, December 1, 1989). Following up on an unofficial October 1989 visit to Japan by PLO chairman Yasir Arafat, the head of the PLO's Economic Affairs and Planning Department held a working-level meeting in Tokyo with Foreign Ministry officials April 24. Ahmed Abu Al'a urged Japan to deal directly with Palestinian institutions in terms of aid, trade and diplomatic relations, bypassing Israel entirely. Tokyo pledged humanitarian help through both bilateral and multilateral channels and assistance to the ongoing peace process but did not provide any specifics.

Jon Choy

Environment Fund Proposed To Asian Development Bank

Reinforcing the idea that development -- its middle name -- can go hand in hand with environmental concerns, the Asian Development Bank at its May 2-4 meeting in New Delhi, India heard a variety of "green" proposals, foremost of which was an offer from Tokyo for a new environmental preservation fund. Finance Minister Ryutaro Hashimoto proposed that roughly Y600 million ($4 million at Y150=$1.00) of a planned Japanese contribution of about Y8 billion ($53.3 million) to the ADB's special Japan Fund be set aside for environmental projects. The two-year-old fund finances programs chosen by Japan but run by ADB.

ADB, whose largest contributing member is Japan, expects to have a dual environmental preservation/poverty alleviation theme in the coming year, according to its new president, Kimimasa Tarumizu of Japan. Among the proposed tasks is a five-year educational program to familiarize ADB staff with environmental concerns in their areas of expertise.

Although environmentalists may welcome the additional funds, they are wary about whether such monies truly preserve natural resources or enhance sustainable development. Richard Forrest of the National Wildlife Federation critically described in a November 1989 report one ADB dam-building project, which also had the financial support of Tokyo's Overseas Economic Cooperation Fund and Japan's private sector. The 1982-85 construction of a 92-megawatt hydroelectric dam in Malaysia affected a native tribe of 3,000 people and submerged 21,000 acres of tropical rainforest. While Mr. Forrest acknowledged that the project was not as bad as some developments, he criticized a Japanese review that praised the project for "raising the living standards of the local inhabitants and preserving forest resources" but ignored the cost to the relocated people.

Mr. Forrest's report, Japanese Economic Assistance and the Environment: The Need for Reform, suggested: ". . . what seems needed from Japan is not funding for more projects, but aid of a very different kind, with much greater efforts to ensure that projects are environmentally and socially sound in their implementation." As indicated by ADB's intent to train staff to incorporate environmental considerations in their projects and Japan's adoption of new environmental guidelines for foreign aid (see JEI Report No. 10A, March 9, 1990), such advice is receiving serious consideration. Evidence of just how serious can be found in Japan's proposed FY 1990 budget, which roughly triples funding for both environmental foreign aid and environmental impact assessments (see Table 1). A further breakdown (see Table 2) indicates that some of this money will go toward sustainable development in developing countries; other funds will be used to address global environmental conservation measures, such as those associated with global climate change.

Table 1: Proposed FY 1990 General Account Expenditures for Environmental Measures

(in billions of yen and millions of dollars*)

	Initial FY 1989 Budget		Proposed FY 1990 Budget		Percent Change in Yen
Overview	(yen)	(dollars)	(yen)	(dollars)	
General Expenditures	Y44.1	$294.0	Y60.0	$400.0	35.9%
Satellite and Other Research	25.9	172.7	21.9	146.0	-15.2
Energy Programs	354.7	2,364.7	369.3	2,462.0	4.1
Miscellaneous	0.9	6.0	1.0	6.7	16.2
Total	425.6	2,837.4	452.3	3,014.7	6.3
Specifics					
International Treaty Coordination	4.9	32.7	6.4	42.7	31.1
Monitoring and Research	60.7	404.7	60.2	401.3	-0.9
Technology Development and Transfer	358.7	2,391.3	381.5	2,543.3	6.4
Environmental ODA	0.5	3.3	1.4	9.3	204.2
Environmental Impact Assessment	0.7	4.7	2.6	17.3	263.6
Public Education	0.1	0.7	0.2	1.3	34.7
Total	425.6	2,837.4	452.3	3,015.2	6.3

Table 2: Proposed FY 1990 Environment Agency Budget for International Conservation

(in billions of yen and millions of dollars*)

	Initial FY 1989 Budget		Proposed FY 1990 Budget		Percent Change in Yen
Project	(yen)	(dollars)	(yen)	(dollars)	
International Organizations	Y6.9	$46.0	Y7.9	$52.7	14.5%
International Aid for Sustainable Development	6.3	42.0	9.1	60.7	44.4
Developing Country Environmental Conservation	---	---	1.9	12.7	---
International Aid for Flora and Fauna in Third World	10.6	70.7	13.1	87.3	23.6
Total	23.8	158.7	32.0	213.3	34.5
Of which ODA:	10.0	66.7	18.5	123.3	85.0

*Converted into dollars at Y150=$1.00.

Source for Tables 1 and 2: Environment Agency

As Japan pushes toward fulfilling its 1988 commitment made at the Toronto economic summit to disburse roughly Y300 billion ($2 billion at Y150=$1.00) for environmental foreign aid over the following three years, environmentalists will be looking for quality as much as quantity. Never known to harbor a bureaucracy that has thrown money at a problem, Tokyo will find that neither can it simply fund multilateral organizations that might inadequately oversee environmental projects. As its economic and political stature grows in organizations such as ADB, so does the weight of Japan's responsibilities.

Pat Murdo

Electoral Reforms Proposed In Japan

A nongovernmental advisory body recommended April 26 that the electoral system for the House of Representatives be based on a mix of single-seat constituencies and proportional representation. The 27-member Election System Council proposed that the number of seats in the lower house be reduced from 512 to 501; of these, 301 would be single-seat districts, while the remainder would be determined by proportional representation. This and related reforms are designed to promote elections based primarily on policy differences among political parties and candidates. They also would facilitate the transfer of power from one party to another, the panel maintained.

Japan's current electoral system for the lower house features more than one representative (usually three to five) per district -- an approach that often pits members of the same party in exorbitantly expensive campaigns against each other for the slots. Some political analysts, in fact, attribute last year's Recruit Co., Ltd. influence-peddling scandal to the money-centered nature of Japanese politics (see JEI Report No. 10A, March 10, 1989). Thus, since his election in August 1989, Prime Minister Toshiki Kaifu has pledged to enact political reforms as a means of restoring the public's faith in Japanese politics in general and in the ruling Liberal Democratic Party in particular.

Although the overriding goal of political reform is to improve the efficiency and the transparency of the election system, the transition may not be easy, judging by the seemingly complex nature of the council's proposals and the reactions of both opposition and ruling party members. For example, under the panel's proposed proportional representation system, the country would be divided into 11 blocks from which 200 winners would be selected from lists of candidates backed by each of the political parties in proportion to the number of votes garnered by each party. This contrasts with the current multiseat system wherein out of a slate of any number of candidates the top three to five vote-getters win the seats (regardless of party affiliation). Under the proposed reform candidates could run in both the single-seat contests as well as place themselves in contention for seats awarded on a proportional basis.

Concerning the single-seat contests, the council urged that the disparity in the relative value of each constituent's vote be narrowed to a two-to-one ratio rather than the current discrepancy of more than three to one. This apparently is aimed at addressing a current phenomenon wherein candidates in certain rural districts can be elected with less than one-third the number of votes required to elect a candidate in a more populous urban district. The council also recommended that an independent organization be established to

RS650-2

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A Two-Part Report: A and B

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THE DEBATE OVER U.S. TRADE POLICY TOWARD JAPAN

Summary

Whether at the White House, on Capitol Hill or in corporate boardrooms, the mainstream trade prescription for lowering the huge bilateral imbalance is opening Japan's markets. The consensus ends there. President Bush and most of his economic advisers are convinced that market forces will do the job, with pressure required only as a backup. Many legislators and a growing number of business executives are equally convinced that this strategy, a carryover from the Reagan administration, is bankrupt. A more activist approach to dealing with Japan is required, they argue, one that is grounded in reality, not the textbook world of free trade.

While recommendations billed as new strategies for handling the "Japan trade problem" generally are lumped under the heading of managed trade, not all of them revolve around numerical targets for Japanese imports or for reductions in the bilateral trade gap. An approach that seems to have broad but largely implicit support in Congress and the business community certainly does not fit that narrow definition. Backers of this plan say the United States should piggyback on the growing movement for change in Japan, applying constant pressure on Tokyo to open markets, threatening retaliation against U.S.-bound Japanese exports if necessary and devising procedures to ensure compliance with market access arrangements already worked out. Negotiating market shares for internationally competitive American products is not ruled out in this approach but is regarded as a last resort.

By staking out a middle ground between free trade and managed trade, proponents of these tactics hope to move the White

House in the direction of a tougher policy on Japan. The Bush administration, however, shows no signs of budging from its current nonconfrontational Japan strategy. Moreover, the chances that legislation incorporating a more activist approach to dealing with Japan will be passed this year are rated slim despite the widespread congressional opinion that "something must be done." Neither are the odds good for significant action on what all sides agree is the fundamental cause of the stubborn U.S.-Japan trade imbalance -- the federal budget deficit.

Defining the "Japan Trade Problem"

After eight years of nonstop growth the U.S. trade deficit with Japan finally topped out at $56.3 billion in 1987 and then dropped to $49 billion last year (see Table 1). The roughly 50 percent slide in the value of the dollar against the yen between September 1985 and the end of 1988 and the shift to domestic demand-led growth in Japan helped both sides of the bilateral trade ledger. Japan-bound exports doubled in the second half of the 1980s, outperforming total U.S. sales abroad by a third. The expansion was broad-based, extending from industrial and agricultural inputs to capital and consumer goods (see Table 2), but manufactured products were the pacesetters by a significant margin. At the same time American purchases of Japanese products, while tracking almost exactly the 37 percent increase in aggregate imports over the 1985-89 period, lagged the rise in the total from 1987 on.

The realignment of the yen-dollar exchange rate and buoyant demand at home from consumers and producers alike also reversed the steadily upward course of Japan's trade surplus, both overall and with the United States. While the reduction in the bilateral gap from its 1987 peak was the result of slower-growing exports and faster-rising imports, the cut in Japan's total figure from a record $82.7 billion in 1986 to $64.3 billion last year was the exclusive work of higher purchases from overseas, particularly of manufactured goods. Counting from 1985, imports of manufactures soared 164.2 percent in dollar terms -- an advance that translated into a 51.4 percent yen-denominated climb and more than a twofold gain on a volume or price-adjusted basis. In the process the closely watched relationship between manufactures and total imports changed from 31 percent in 1985 to 50.3 percent last year (see Tables 3-5).

To many American observers these often-cited numbers convey a deceptive picture of progress on the bilateral and the Japanese trade fronts. They acknowledge that macroeconomic policy changes, exchange rate shifts and the removal of most of Japan's formal import barriers are moving trade flows in the right directions, opening markets in Japan and curbing the expansion of Japanese exports. Their quarrel is with the long list of trade statistics skipped in the usual government presentation. These indicators, it is argued, all point to an unaddressed Japan trade problem, particularly on the import side. Some examples:

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Table 1: U.S. Trade, 1980 and 1985-89

(in millions of dollars; exports f.a.s., imports Customs)

	Exports	Percent Change	Imports	Percent Change	Trade Balance
		Total Trade			
1980	$225,722	21.0%	$245,262	16.6%	$-19,540
1985	218,828	-2.3	345,276	6.0	-126,448
1986	227,159	3.8	369,961	7.1	-142,803
1987	254,122	11.9	406,241	9.8	-152,119
1988	322,426	26.9	440,952	8.5	-118,526
1989*	364,350	13.0	472,926	7.3	-108,576
		Trade with Japan			
1980	20,790	18.3	30,867	17.6	-10,077
1985	22,631	-4.0	68,783	20.4	-46,152
1986	26,882	18.8	81,911	19.1	-55,030
1987	28,249	5.1	84,575	3.3	-56,326
1988	37,725	33.5	89,519	5.8	-51,794
1989*	44,584	18.2	93,586	4.5	-49,002
		Trade with European Community			
1980	58,855	n.a.	38,211	n.a.	20,644
1985	48,994	-3.0	67,822	12.6	-18,828
1986	53,154	8.5	75,736	11.7	-22,582
1987	60,575	14.0	81,188	7.2	-20,613
1988	75,755	25.1	84,939	4.6	-9,183
1989*	86,592	14.3	85,129	0.2	1,463
		Trade with Canada			
1980	40,331	n.a.	41,025	8.2	-694
1985	53,287	2.9	69,006	3.8	-15,719
1986	55,512	4.2	68,253	-1.1	-12,741
1987	59,814	7.7	71,085	4.1	-11,271
1988	71,622	19.7	81,398	14.5	-9,776
1989*	78,588	9.7	88,210	8.4	-9,622
		Trade with Hong Kong, South Korea, Singapore and Taiwan			
1980	14,741	24.1	17,779	11.5	-3,038
1985	16,918	-4.5	39,066	7.4	-22,148
1986	18,290	8.1	46,136	18.1	-27,846
1987	23,547	28.7	57,664	25.0	-34,117
1988	34,816	47.9	63,030	9.3	-28,214
1989*	38,458	10.5	62,756	-0.4	-24,298

*Preliminary

Source: Department of Commerce

Table 2: U.S. Trade with Japan by End-Use Category, 1980 and 1985-89

(in millions of dollars; exports f.a.s., imports Customs*)

	1980	1985	1986	1987	1988	1989
Total Exports	$20,790	$22,631	$26,882	$28,249	$37,725	$44,584
Food, Feed and Beverages	5,393	5,001	5,043	5,555	7,892	8,443
Industrial Supplies	9,501	8,680	8,752	10,156	12,989	15,372
Capital Goods	4,148	5,694	6,428	7,388	9,874	11,331
Automotive Products	192	245	300	382	754	1,034
Consumer Goods	1,154	1,416	1,690	2,551	3,564	4,987
Other Exports	403	1,596	4,670	2,218	2,652	3,418
Total Imports	30,701	68,783	81,911	84,575	89,519	93,586
Food, Feed and Beverages	297	500	504	451	394	344
Industrial Supplies	5,926	7,035	6,949	7,281	8,471	8,464
Capital Goods	6,555	21,516	25,334	28,947	33,853	37,015
Automotive Products	11,436	24,980	32,849	33,695	31,978	33,734
Consumer Goods	6,198	14,017	15,451	13,385	14,083	12,961
Other Imports	289	734	824	817	740	1,068

*1980 imports are valued f.a.s.

Note: The figures for 1988 and 1989 are not strictly comparable to the numbers for earlier years because of minor changes in the end-use classification.

Source: Department of Commerce

- From a peak of $152.1 billion in 1987 the U.S. trade deficit with the world contracted to $108.6 billion in 1989 -- a 28.6 percent shrinkage. Over this period the shortfall in trade with Canada, which had been dropping since 1985, declined 14.6 percent, the deficit with the European Community was replaced by a small surplus and the import-export gap with Asia's newly industrialized countries (Hong Kong, South Korea, Singapore and Taiwan) narrowed 28.8 percent. The U.S. deficit with Japan, however, declined just 13 percent. Moreover, last year's bilateral imbalance still was above the 1985 level. To make matters worse, trade with Japan represented only 16.5 percent of combined U.S. exports and imports in 1989 but 45.1 percent of the overall deficit.

- Although American shipments of manufactured products to Japan soared 118.6 percent between 1985 and last year to $27 billion, bumping the manufactured ratio to 60.5 percent, this number did not measure up to the comparable figures for the European Community (80 percent-plus), Canada (just over 90 percent) or even the Asian NICs (mid-70s). Likewise, Japan-bound high technology exports, while on the upswing in the second half of the 1980s, made up a smaller portion of sales -- roughly 30 percent -- than the equivalent statistic for the European Community -- about 45 percent. In addition, this country consistently ran a big deficit in high technology trade with Japan but sold substantially more of these products to the European Community than it bought.

Table 3: Japan's Imports of Manufactured Products, 1980 and 1985-89

(in millions of dollars/billions of yen; c.i.f. value)

	Dollar Terms		Yen Terms		Share of Total Imports
	Total	Percent Change	Total	Percent Change	
1980	$32,110	6.2%	Y7,304	16.5%	22.8%
1985	40,157	-1.1	9,636	0.2	31.0
1986	52,781	31.4	8,896	-7.7	41.8
1987	65,961	25.0	9,575	7.6	44.1
1988	91,838	39.2	11,770	22.9	49.0
1989	106,111	15.5	14,588	23.9	50.3

Source: Japan Tariff Association

Table 4: Japan's Imports of Manufactured Products by Major Supplier, 1985-89

(in millions of dollars; c.i.f. value)

	Total		United States		European Community		Asian NICs*	
	Amount	Percent Change	Amount	Percent Change	Amount	Percent Change	Amount	Percent Change
1985	$40,157	-1.1%	$14,2436	1.9%	$7,691	-5.8%	$5,689	-0.8%
1986	52,781	31.4	17,645	23.9	11,956	55.4	7,803	37.2
1987	65,961	25.0	17,672	0.2	15,146	26.7	12,459	59.7
1988	91,838	39.2	23,540	33.2	20,770	37.1	18,234	46.4
1989	106,111	15.5	28,119	19.5	24,193	16.5	20,495	12.4

*Hong Kong, South Korea, Singapore and Taiwan.

Source: Ministry of Finance

- Despite the rapid expansion of foreign purchases by Japan, manufactured imports do not play as big a role in the economy as they do in its two major industrial rivals. Manufactures represented 80 percent of total imports in the United States in 1989 and an estimated 75 percent in West Germany compared to Japan's 50.3 percent figure. Moreover, while the ratio of total imports to gross national product is far lower in both Japan and the United States (7.4 percent and 9 percent, respectively, last year) than in West Germany (22.4 percent), Japan becomes the odd man out when the measure is purchases of manufactured products from abroad. At 3.7 percent in 1989, its imported manufactures-to-GNP ratio was considerably below the 9 percent U.S. statistic and especially the West German figure of 15.6 percent (1988). Similarly, in 1988 Japan imported only $749 worth of manufactures per person versus $1,468 for this country and $3,075 for West Germany, the Department of Commerce calculated, even though all three had roughly equivalent per capita GNPs.

For numerous trade watchers these and similar statistics add up to just one conclusion: Japan's imports of manufactures, whether from the United States

Table 5: Japan's Imports of Capital amd Consumer Goods by Major Supplier, 1980 and 1985-89

(in millions of dollars; c.i.f. value)

	1980	1985	1986	1987	1988	1989
Capital Goods	$9,096	$11,541	$13,229	$16,328	$22,341	$26,637
United States	4,888	7,504	7,785	9,025	12,250	14,434
European Community	2,247	1,845	2,763	3,606	4,513	5,107
Southeast Asia	790	1,179	1,473	2,313	3,662	4,926
Consumer Nondurables	2,677	3,319	4,711	7,718	10,706	13,603
United States	322	314	403	857	1,200	1,531
European Community	697	692	1,008	1,400	1,928	2,741
Southeast Asia	1,167	1,574	2,368	4,093	5,548	6,417
Consumer Durables	2,395	2,974	4,601	7,977	11,938	15,431
United States	561	590	740	1,086	1,711	2,326
European Community	855	1,105	1,949	3,575	5,322	7,176
Southeast Asia	672	873	1,393	2,538	3,809	4,241

Source: Japan Tariff Association

or elsewhere, are substantially less than would be expected for a country of its economic standing. That finding holds, they note, even when allowance is made for Japan's resource endowment, geographic location and other economic factors (see JEI Report No. 14A, April 8, 1988). In this view trade barriers, now mostly informal, are the major explanation for Japan's subpar import performance.

A Look Back

The belief that trade with Japan presents unique problems is hardly new. Nor are the accompanying calls for a tailor-made Japan strategy. The same conviction shaped a number of Japan-specific or Japan-motivated market access resolutions and bills in the mid-1980s as the U.S. trade deficit, fueled solely -- or so it was portrayed -- by a flood of red ink in the bilateral account, started rocketing out of control. Legislators on both sides of the aisle constantly railed against the Reagan administration's management of trade issues with Japan. They claimed that the White House's generally hands-off approach to the unfair trade practices allegedly behind the soaring U.S.-Japan imbalance (and, by extension, the overall deficit) amounted to no policy at all. By default, therefore, Congress had to take up the cause of American trade interests at home and in Japan.

Reagan administration trade officials bristled at the charge that they had no policy for dealing with Japan on market access issues, but they were hard-pressed to defend their negotiating record. The strategy of trying to gain improved access by targeting one specific problem area -- beef and orange quotas, for example -- and then moving on to another one product-one issue area had netted only piecemeal results after usually protracted bargaining. This scorecard, it was concluded, would not douse the protectionist fires on Capitol Hill; an entirely different approach was needed.

The White House's answer was in-depth sectoral negotiations to improve Japanese market opportunities for highly competitive American exports. Previewed during 1984 financial liberalization talks, this negotiating tactic came into its own at the beginning of 1985 with the launch of the awkwardly named market-oriented, sector-selective discussions. The idea behind the MOSS format was deceptively simple: pick a handful of product areas where Japanese restrictions prevented U.S. manufacturers from fully exploiting their technological or pricing edge and then tackle the full range of barriers that could impede access.

Selected for initial treatment were four product groups that had been the subject of previous market access negotiations -- telecommunications equipment and services, medical equipment and pharmaceuticals, sophisticated electronics, and forest products. Automotive products were added in 1986. No deadline was set for the talks, although it was clear to trade officials in both countries that steady progress had to be made if the discussions were to have any impact on Capitol Hill's get-tough-on-Japan mood. Neither did the administration establish dollar targets for export increases to measure the success of the negotiations, a decision that followed considerable internal debate.

Despite negotiating gains, the MOSS talks failed to convince congressional trade hawks that the White House had a trade strategy, either for Japan or for the generic problems hamstringing U.S. exporters. By late summer 1985 passage of at least one import-restrictive piece of legislation and possibly a few others seemed a safe bet. These odds finally forced the administration to go on the offensive. In a major trade policy initiative announced in September, President Reagan unveiled a strategy of "free and fair trade," featuring a program to combat unfair foreign trade practices and a commitment to take the lead in the movement toward a new round of multilateral trade negotiations under the General Agreement on Tariffs and Trade. Foreign trade practices that damage American interests no longer will be tolerated, the chief executive said in a speech directed equally at congressional critics of his trade policy and at Japan and other U.S. trading partners. He spelled out a plan to enforce trade statutes more aggressively and to set up an interagency "strike force" to pinpoint unfair trade practices and develop ways to eliminate them.

The White House actually had previewed its new harder line on unfair foreign trade practices earlier in the month when it took the unprecedented step of self-initiating three investigations under Section 301 of the 1974 Trade Act, including one against Japan's restrictions on sales of foreign cigarettes. At the same time the president gave Tokyo less than three months to resolve a long-running dispute over import quotas on leather and leather footwear, another step never before taken by Washington. Then in December 1985 Mr. Reagan, endorsing the first recommendation of his trade strike force, gave the Commerce Department the green light to start an antidumping investigation of memory chips imported from Japan, another precedent-setting action.

These demonstrations of a White House on the move against Japan and other major U.S. trading partners, including the European Community, persuaded many initially skeptical legislators that the administration in fact had a substantive trade policy. More than anything, though, the five-nation agreement orchestrated by the United States to lower the dollar's sky-high value -- reached the day before Mr. Reagan unveiled the new U.S. trade strategy -- alleviated congressional frustration over the handling of trade issues. This pact marked a significant policy shift for the administration, which previously had viewed the strong dollar as a reflection of U.S. economic strength rather than as a primary cause of the surging bilateral and overall trade deficits.

Having switched trade and exchange-rate policy gears, administration economic officials basically sat back and waited for the falling dollar to correct the towering trade imbalance. That was a tactical mistake. Influential lawmakers soon started to wonder aloud whether they could count on the White House to continue the crackdown on unfair trade practices in Japan and elsewhere. This questioning plus the initially perverse effects of the dollar's drop on the U.S. trade account supplied new momentum in 1986 to the drive for trade legislation. By then, however, the attraction of country- and product-specific protectionist measures had faded, replaced by a growing consensus on Capitol Hill that general trade reform represented a more constructive response to this country's multiplying trade problems.

In drafting language that would force the White House's hand on unfair foreign trade practices, congressional leaders were swayed by the checkered results of the MOSS talks and other administration efforts to open markets in Japan. Along with an increasing number of American businessmen, many representatives and senators had come to the conclusion that negotiating the removal of import barriers in Japan was a never-ending process; the elimination of one obstacle to sales just revealed another. They also were convinced that Washington allowed market access negotiations with Tokyo to drag on and often settled for a Japanese response short of the administration's initial goal. The reluctance of the White House to retaliate against Japan for allegedly inadequate compliance with market-opening agreements irked these critics as well. Moreover, they faulted U.S. trade policymakers for failing to target what appeared to be obvious roadblocks to American exports, including such informal barriers as Japan's distribution system and its buy-national psychology. But perhaps most troubling to frustrated legislators and business executives was the administration's reactive, ad hoc policy on Japanese market access issues.

These complaints found several forms of legislative expression in the three years it took an omnibus trade bill to get through both houses of Congress. The most publicized outlet was an amendment to the 1986 House bill by Richard Gephardt (D, Mo.). A watered-down version of a plan he and other Democrats had sponsored in 1985, the measure required the president to negotiate agreements with Japan and other countries running big trade surpluses with the United States and the world, aiming for 10 percent annual reductions in their bilateral surpluses. Failure to achieve these cutbacks would force the White House to act to bring down recalcitrant countries' imbalances. If the surpluses still did not drop, the president would have to impose import quotas to achieve the surplus-reduction goals.

Although extreme, the Gephardt amendment was indicative of the House's get-tough stand on closed foreign markets. A revamped, slightly less protectionist variant of this measure surfaced in the 1987 House-passed trade bill, but it had no counterpart in the Senate's version. Considered certain veto bait, the Gephardt amendment was dropped in the spring of 1988 by the House-Senate conference on HR 3. But Democrats and Republicans trying to force White House action on Japanese import barriers did not come up empty-handed. The so-called Super 301 provision of the 1988 Omnibus Trade and Competitiveness Act, signed into law that August, implicitly was crafted to open markets in Japan.

Round Two

Lawmakers soon discovered that they could tailor a Japan trade strategy for the executive branch but could not keep the White House from making alterations on its own. A deeply divided Bush administration named Japan a priority country under the Super 301 framework in May 1989, but instead of targeting a broad range of problem practices and products for negotiation and possible retaliation if bargaining failed to produce results over 12 months, the president's top advisers compromised. Chosen for Super 301 coverage were the three issues with the best prospects for successful negotiations -- exclusionary government procurement of supercomputers and satellites and a variety of restrictions on wood products. Aware that this limited move would not play well with Capitol Hill or Japan hard-liners in his cabinet, Mr. Bush also endorsed bilateral talks outside the Super 301 format on government and corporate policies and practices that impede access to Japanese markets.

The White House recognized that the Structural Impediments Initiative was a risky strategy for dealing with market access problems in Japan. The most Washington could achieve during the year-long process would be specific commitments from Tokyo for reforms in the six targeted problem areas and some first steps toward change. Full implementation of promised reforms would require time; even then it might take up to five years for any results of the SII discussions to show up in the U.S. export figures. Whether a Congress interested in quick fixes for the still huge bilateral trade deficit would wait that long was an open question.

Despite reservations legislators influential on trade matters were willing to give the administration at least some time to demonstrate that its market-opening approach would work. A number of people in the private sector, however, already had written off any attempt to negotiate an end to generic or systemic obstacles to imports, whether as part of the retaliatory Super 301 process or outside it. Their reasoning, in very simplified terms, is that it is unrealistic to expect meaningful concessions from Tokyo on what Washington labels structural or invisible barriers since these government and business policies and practices are keys to Japan's international economic strength. Rather than constantly straining the vital U.S.-Japan economic and political relationships by trying to negotiate the impossible, say some leading proponents of this revisionist line, the United States should establish quantitative import goals for Japan or numerical targets for the bilateral trade imbalance. In one version of Gephardt revisited Japanese imports of American manufactures would have to expand 15 percent a year in real terms or Washington would retaliate.

Managed trade proposals like this one have been condemned on almost all fronts. Economists argue that this strategy would reinforce aspects of how Japan conducts business that already are of concern to the United States. The Ministry of International Trade and Industry would have to organize numerous purchasing cartels and track closely their orders. Companies would be forced to collude to decide which one would buy what and how the imports would be sold. There also is the question of how American suppliers would divvy up the orders. In short, bureaucratic actions would replace market forces, just as they have with the restraint arrangements covering various U.S.-bound Japanese exports.

The broadbrush managed trade approach of the revisionist camp also is anathema to corporate America, but in recommending a new Japan trade strategy to the Bush administration soon after it took office, top executives from several dozen of this country's big multinationals edged in that direction. The main requirement for the United States, the Advisory Committee for Trade Policy and Negotiations stated, is a cut in the federal budget deficit; without that step and expansionary macroeconomic policies in Japan, any attempt to rectify the bilateral imbalance will be doomed. Then, on the trade side, Washington needs what the group called a results-oriented policy.

Its proposal for tackling formal Japanese barriers to imports was patterned after the much-maligned MOSS format: identify those product areas where American suppliers are internationally competitive but unable to break into the Japanese market; establish sectoral negotiating priorities; define specific goals for "successful outcomes;" and, finally, negotiate the elimination of the restrictive measures. For informal or invisible barriers, however, ACTPN advocated sectoral import targets. In both cases Washington should devise procedures to monitor implementation and react decisively if Japan does not keep its commitments, either by filing a GATT complaint, self-initiating a regular Section 301 investigation or retaliating.

Viewed as a beefed-up Super 301, the advisory group's results-oriented Japan strategy has considerable backing on Capitol Hill. Whether this support can be translated into action is another matter. Despite some tough talk on Capitol Hill right before and immediately after the White House's late April decision to drop Japan from the Super 301 list (see JEI Report No. 18B, May 4, 1990), analysts say a full congressional calendar in this year's elections-shortened session makes passage of a Japan-targeted bill unlikely.

Next year could be a different story. The market-opening arrangements worked out this spring for supercomputers, satellites and wood products and Tokyo's early April plan for dismantling structural barriers to trade will have a marginal impact at best on American exports, which must expand more than twice as fast as imports of Japanese-made products just to keep the U.S.-Japan trade deficit at 1989's politically explosive $49 billion level. With the dollar strengthening against the yen over the past 17 months and some signs of softer domestic demand in Japan, the bilateral trade imbalance could widen again in 1991. That could provide the necessary momentum on Capitol Hill for a get-tough-on-Japan bill.

For further information, contact Susan MacKnight.

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The views expressed in this report are those of the author and do not necessarily represent those of the Japan Economic Institute.

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JEI REPORT

A Two-Part Report: A and B

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IN THIS ISSUE:

Kaifu's South Asia Initiative 1

Japan's Current Account Surplus Drops 3

Allegations of Antitrust Violations
Heard On Capitol Hill 5

USTR Makes No Bid
On Japanese Construction Issue 8

Notes: Super 301;
Telecommunications Trade 9

Kaifu's South Asia Initiative

On his April 28-May 6 tour of five South Asian nations Prime Minister Toshiki Kaifu trod a narrow line between Tokyo's desire to extend greater political and economic influence to this part of the world and its reluctance to get involved in regional disputes. Speaking before an April 30 joint session of India's two-chamber parliament, Mr. Kaifu offered to promote a greater political and economic dialogue between Tokyo and the region, expand development assistance and encourage cultural exchange and cooperation "in order to give further depth and breadth to Japan's relations with South Asian countries." In addition, the prime minister said that Japan is ready to provide a wide range of assistance to the seven-nation South Asian Association for Regional Cooperation, which is devoted to fostering economic, technical, social and cultural development in the region. He also indicated that Tokyo's recent commitment of economic assistance to Eastern Europe will "in no way weaken our determination to attach high priority to South Asia" -- an attempt to allay apparent concerns that the needs of these countries would be forgotten as Japan joins other members of the Western alliance in supporting the nascent political and economic reform movement in Eastern Europe.

earmarked for the FY 1988-FY 1989 period) apparently was particularly fearful that Japan's growing interest in supporting Eastern European development would result in cuts in its ODA allotment. Mr. Kaifu assured Indonesian President Suharto that the aid Japan plans to extend to his country in FY 1990 will remain at approximately the same level as in the previous two years.

Tokyo remains wary of becoming embroiled in regional political problems. One such trouble area concerns a dispute between India and Pakistan over the secessionist movement in Kashmir, the only Moslem state in predominantly Hindu India. Pakistani Prime Minister Benazir Bhutto suggested that she would like to see Japan assume the role of mediator in this dispute. Mr. Kaifu, however, would not go beyond urging both countries to exercise self-restraint in reaching a peaceful solution to a dispute that twice since 1947 has brought India and Pakistan to arms. Although it could be argued that its economic power in the region has attendant political responsibilities, Tokyo still believes quite strongly that its best contribution to South Asian stability is through its foreign aid program.

Barbara Wanner

Japan's Current Account Surplus Drops

The first three months of this year reverberated with the turbulence of Japan's financial markets. The stock market plummeted, interest rates rose and the already weak yen continued to lose strength. Americans naturally asked what all this uncharacteristic commotion in Japan would mean for them. Some U.S. analysts braced for the worst, recalling that the 1987 stock market crash had seemed to demonstrate how interrelated world financial markets had become. However, Wall Street's comparative strength in the face of the almost daily distress on the Tokyo stock market provided preliminary clues that the damage might be more limited than at first predicted. The January-March balance of payments statistics, released in early May, give further reassurance. These figures, as always, can be read in one of two ways: as the difference between exports and imports of goods and services or as a comparably broad concept of capital outflow. In other words, the larger the current account surplus, the bigger the capital outflow. The first quarter current account made news by behaving predictably despite the turmoil on Japanese markets; it declined 22.8 percent in dollar terms from a year earlier (see Table 1).

The interpretation of the current account figure as a capital flow is the more relevant one for assessing the effects of the financial market turmoil. Some experts had expected that Japanese investors, facing losses on their domestic stock and bond holdings, would withdraw from foreign markets to cover their losses. Unless offset by sharply higher official capital movements or other kinds of outflows, this action would have led to a sharply lower current account surplus. The relatively small decline in the current account provided a hint that this did not happen.

Looking more carefully at individual accounts provides confirmation that the first three months of 1990 were comparatively strong compared to the initial quarters of previous years. For example, the net long-term capital outflow was nearly triple the first quarter 1989 amount and somewhat higher than in the January-March 1988 period. Japanese net purchases of foreign bonds did fall dramatically but remained in the positive column (see Table 2). However, Japanese net purchases of foreign stock were sharply higher than in the first quarters of 1988 and 1989. Taken together, these numbers suggest that Japanese

Table 1: Japan's Balance of Payments

(in millions of dollars)

	Trade Balance	Exports (f.o.b.)	Imports (f.o.b.)	Services (net)	Current Account Balance	Long-Term Capital (net)
1985	$55,986	$174,015	$118,029	$-5,165	$49,169	$-64,542
1986	92,827	205,591	112,764	-4,932	85,845	-131,461
1987	96,386	224,605	128,219	-5,702	87,015	-136,532
1988	95,012	259,765	164,753	-11,263	79,631	-130,930
1989	76,917	269,570	192,653	-15,526	57,157	-89,246
1988: I	21,021	59,345	38,324	-1,337	18,421	-15,142
II	22,448	63,559	41,111	-2,882	18,567	-36,556
III	23,765	65,989	42,224	-3,623	19,052	-42,214
IV	27,778	70,872	43,094	-3,421	23,591	-37,018
1989: I	21,311	66,945	45,634	-3,595	16,064	-5,612
II	19,794	66,560	46,766	-4,892	14,283	-30,801
III	19,770	68,157	48,387	-4,023	14,957	-21,559
IV	16,042	67,908	51,866	-3,016	11,853	-31,274
1990: I (p)	14,572	65,235	50,663	-779	12,404	-16,428

Table 2: Japan's Net Purchases of Foreign Securities

(in millions of dollars)

	Bonds			Stocks		
	Purchases	Sales	Net	Purchases	Sales	Net
1985	$291,338	$237,859	$53,479	$5,484	$4,489	$995
1986	1,346,989	1,253,965	93,024	20,917	13,869	7,048
1987	1,273,829	1,200,944	72,885	70,936	54,062	16,874
1988	1,364,061	1,278,249	85,812	76,560	73,567	2,993
1989	1,683,733	1,589,650	94,083	97,056	79,169	17,887
1988: I	332,047	318,877	13,170	18,901	19,467	-566
II	401,293	374,371	26,922	20,518	20,643	-125
III	333,473	307,635	25,838	25,166	23,425	1,741
IV	297,248	277,366	19,882	11,975	10,032	1,943
1989: I	341,774	327,771	14,003	17,724	17,828	-104
II	487,087	461,996	25,091	21,228	15,120	6,108
III	463,493	437,622	25,871	23,602	18,807	4,795
IV	391,379	362,261	29,118	34,502	27,414	7,088
1990: I (p)	356,393	355,524	869	27,640	22,694	4,946

investors did not sell off their foreign holdings and even may have substituted American and European stocks for Japanese equities to a modest degree in response to the weakness in the Tokyo market.

Even the unusually small net increase in foreign bond holdings offered more positive news for the stability of international capital markets than it might have appeared. The Bank of Japan has been pushing up interest rates since mid-1989 in an effort to increase the returns on investment in Japan, thereby hoping to increase the demand for yen and raise the value of the Japanese currency. Of course, a precipitous retreat from foreign bond markets would be destabilizing. The figures suggest that the equivalent of a soft landing in the flow of capital has been successfully implemented. The crash that could have resulted from a Japanese pullout has been avoided, and at least some outbound investment flows have declined significantly.

The current account figures as trade statistics demonstrate why BOJ's success with regard to strengthening the yen could be critical. Some experts claim that the recent apparent progress in reducing the current account surplus has been purchased with a J-curve: the yen's weakness implies that exports and imports have been denominated in more expensive dollars, making the imbalance appear smaller for a few months before growing again. While the January-March quarterly figure was down a comfortable amount from a year earlier, the yen's sustained weakness may have begun to adversely affect the results, hinting at a bend in the "J."

In sharp contrast to the deficit in the current account registered in January and a healthy year-to-year decline in the February surplus, the $8 billion surplus in March exceeded the year-earlier figure. In addition, the deficit in services, a major factor in the five straight year-to-year declines in the quarterly current account, turned to surplus for the month and practically disappeared for the three-month period. In the past the services figure has been extremely sensitive to exchange rate changes. These factors suggest that further long-run progress in reducing the current account surplus is problematic unless the yen strengthens. The capital account figures compared to a year earlier, together with the stabilization of the yen in April and early May, are grounds for optimism on this score.

The latest figures rounded out Japan's 1989 fiscal year, which ended March 31. The FY 1989 current account surplus of $53.5 billion was substantially under the government's initial $71.1 billion outlook made more than a year ago and the revised figure of $61 billion anticipated as of last December. The greater-than-expected apparent progress was at least partly a result of the unexpectedly weak yen and the J-curve. Those who expect the yen to weaken further logically could expect a still smaller current account surplus in FY 1990. Ironically, BOJ's attempts to strengthen the yen, if successful, could result in a reversed J-curve that could lift the FY 1990 current account surplus above that of FY 1989.

Douglas Ostrom

Allegations Of Antitrust Violations Heard On Capitol Hill

The House Judiciary Committee's subcommittee on economic and commercial law heard arguments May 3 that the United States must guard against violations

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REPORT

A Two-Part Report: A and B

NO. 20B
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IN THIS ISSUE:

FY 1990 Budget Clears Main Hurdle 1

Prospects Dim For Formal
Opposition Party Coalition 2

Congress Reacts To Super 301 Decision 5

Tokyo Backs Eased Export Controls 7

Notes: Construction Talks;
Car Export Quota;
Satellite Launch Business 8

FY 1990 Budget Clears Main Hurdle

The FY 1990 general account budget, which totals Y66.2 trillion ($441.6 billion at Y150=$1.00), finally passed the lower house May 10 and now awaits action in the upper house. However, the House of Councillors, in which the opposition parties have a majority, is expected to reject the budget proposal sometime in late May as a way of voicing opposition to the continuation of the 3 percent consumption tax. The ruling Liberal Democratic Party included only minor changes in the consumption tax in its FY 1990 budget proposal. Since the Japanese constitution gives the lower house precedence over the upper chamber on budget matters, the FY 1990 budget will go into effect June 9 -- 30 days after its passage by the lower house. This will happen even if the upper house votes against the plan.

Since the FY 1990 budget was in limbo for the April 1 start of the fiscal year, the Diet passed a 50-day provisional budget of Y10.2 trillion ($68 billion). This stopgap measure will expire May 20, and the administration of Toshiki Kaifu will have to prepare a second temporary authorization, the first time such a move has been needed since 1955. The second spending bridge is for Y2 trillion ($13.3 billion) for 19 days starting May 21.

Although the FY 1990 budget will go into effect in early June, the fight over the consumption tax is expected to continue. The opposition parties used Diet consideration of the budget to protest the controversial consumption tax. To break the political stalemate the LDP and the opposition parties finally agreed in early May to set up special committees on taxation in both chambers. These committees will address primarily problems related to the consumption tax and tax reform. The upper house committee is expected to be under the direction of Yoshio Inoue, a former head of the Hokkaido and Okinawa Development Agencies. The lower house committee is scheduled to be chaired by Taku Yamazaki, an ex-director general of the Japan Defense Agency and a former vice cabinet secretary. Political analysts note that Mr. Yamazaki not only has no expertise on tax matters but as a member of the small LDP faction led by Michio Watanabe lacks political clout within the party. His nomination suggests to them that the LDP is not prepared to compromise on the consumption tax by freezing or abolishing it in the future. Rather, the LDP, which regained confidence after winning big in the February 18 lower house elections, has begun to attack the opposition parties, charging that abolition of the consumption tax is unrealistic and fiscally irresponsible.

The Japan Socialist Party, the biggest opposition group, has maintained its past stance urging repeal of the tax. Komeito and the Democratic Socialist Party, which were damaged in the February lower house elections because of their image of being JSP puppets, gradually have been changing their attitude toward the consumption tax to separate their political image from that of the JSP in the public's eyes. The possibility that one or both of these parties could form an upper house coalition with the LDP rather than the JSP makes the matter more complicated (see article in this issue).

In order to change, freeze or abolish the consumption tax, both chambers must pass amendments to the tax code. If the current Diet session, which ends June 26, cannot agree on modifications to the consumption tax legislation, then initial FY 1990 general account revenues will be revised upward. How much depends on the proposal, but the LDP compromise included in the FY 1990 budget is estimated to cost the government Y87 billion ($580 million) in lost revenue. Many analysts see a very slight chance of reaching agreement on change. They forecast that consideration of the consumption tax will be put off and addressed as the main agenda item in the special Diet session expected to be held in the autumn.

Hideo Takahashi

Prospects Dim For Formal Opposition Party Coalition

The prospect that a coalition of noncommunist opposition parties could wrest government control from the ruling Liberal Democratic Party has faded considerably in recent months, primarily due to ideological differences and weak leadership. But alignments with the LDP are not so obvious either.

Japan's political opposition has been exploring the possibility of a coalition since spring 1989. The Japan Socialist Party's unprecedented gains in the July 1989 upper house contests -- a victory that usurped LDP control of this chamber -- appeared to give additional impetus to the prospect of a formal

JSP/Komeito/Democratic Socialist Party alliance (see JEI Report No. 32A, August 18, 1989). However, the Socialists' ideological rigidity and purely reactive strategy in opposing LDP-led government initiatives continue to impair the JSP's ability to forge ties with the other two noncommunist parties. Some analysts suggest that the outcome of an upcoming special election to fill an upper house vacancy will indicate whether Komeito and the DSP will align informally with the ruling party in the upper chamber, at least on selected issues.

Voters in Fukuoka prefecture will go to the polls June 10 to select a successor to Akira Ono, a recently deceased JSP member. If a ruling party candidate wins, the LDP then would hold 112 seats in the upper house. (The LDP's tally has increased by two since last July due to realignments by conservative independents.) According to some Japanese political commentators, the ruling party could reclaim control of this chamber if it can persuade the three members of the Taxation Party to join its ranks along with two independent Diet members, Kiyoshi Nishikawa and Issei Sawada -- all of whom share philosophies quite similar to the LDP's on the controversial consumption tax. If the LDP then could win backing from the DSP, which has 10 upper house seats, it would have an informal coalition of 127, two more than the combined total of 125 for the JSP, Komeito, the Japan Communist Party, Rengo and minor parties and independents (see Tables). The DSP's new chairman, Keigo Ohuchi, reportedly has indicated a greater willingness to cooperate with the ruling party on selected issues.

Table 1: Current Upper House Party Alignment

Party	Seats
Liberal Democratic Party	111
Japan Socialist Party	73
Komeito	20
Japan Communist Party	14
Democratic Socialist Party	10
United Social Democratic Party	0
Taxation Party	3
Rengo	12
Minor Parties	6
Independents	2
Total	251*

*One seat is vacant.

In mid-March the Socialists revealed an "action plan" for 1990 that urged a revamp of the party's organization, policies and campaigns. However, the plan fails to offer a coherent policy platform that could stand as an alternative to the LDP's. While, for example, the JSP has softened its historic opposition to the U.S.-Japan Mutual Security Treaty, stating support for the treaty if the opposition came to power, the plan does not elaborate on the JSP's foreign policy posture. In addition, JSP members are urged to cultivate relations with environmental groups, women's organizations and other civic groups, but no domestic policies of interest to these groups are spelled out.

Table 2: February 18, 1990 Lower House Election Results

Party	Seats After July 1986 Elections	Seats When Diet Dissolved January 1990	Seats After February 1990 Elections
Liberal Democratic Party	300	295	286
Japan Socialist Party	85	83	141
Komeito	56	55	46
Japan Communist Party	26	27	16
Democratic Socialist Party	26	26	14
United Social Democratic Party	4	4	4
New Liberal Club	6	0	0
Progressive Party	0	1	1
Independents	9	4	4
Total	512	495*	512

*17 seats were vacant at the time of the February 18 elections.

A principal plank of the plan remains staunch opposition to the LDP-led government's 3 percent consumption tax. However, JSP-orchestrated passage in the upper house last year of legislation that would abolish the tax was not accompanied by what many economists consider concrete, fiscally responsible substitute tax measures. Had the JSP chosen to cooperate with the ruling party rather than taking a rigid stand, political analysts say, it might have realized even greater reductions or exemptions to the tax than currently are under consideration.

This lack of policy "vision," attributable in large part to ideological cleavages within the JSP itself (see JEI Report No. 12A, March 23, 1990), apparently has frustrated the DSP and Komeito, which are anxious to become more active participants in the governing process. Komeito chairman Koshiro Ishida, in fact, has attempted to distance his party from the JSP. Declaring that Japanese politics needs a "third pole" between the LDP and the JSP, Mr. Ishida told the Komeito annual convention in mid-April that the party should clarify its role as the leading "centrist party." He also was sharply critical of the Socialists' inability to forge a working noncommunist opposition party coalition due to its stubborn refusal to compromise on defense and other issues. Komeito and the DSP support the U.S.-Japan Mutual Security Treaty and Japan's self-defense posture.

As mentioned, the DSP, which was weakened by a poor showing in the February 1990 lower house elections, appears to be leaning toward a more cooperative relationship with the ruling party. In addition to objecting to the JSP's intransigence, the DSP along with Komeito also no doubt are examining public opinion polls, which indicate far less support than they did last summer for a coalition government led by noncommunist opposition parties.

Regardless of what happens in Fukuoka next month, the chances are slim for any type of major party coalition. The DSP, for example, has yet to formally abandon its opposition to the LDP-sponsored consumption tax. In addition, other controversial legislation that the LDP-led government is committed to enacting -- namely, reforms of Japan's electoral system (see JEI Report No. 18B, May 4, 1990) -- could hurt both the DSP and Komeito. They have much to lose from the proposed electoral changes and can be expected to oppose the legislation. While a coalition with the JSP may be dead, these two smaller parties still appear wary of throwing their lots in with the LDP.

Barbara Wanner

Congress Reacts To Super 301 Decision

Members of the commerce, consumer protection and competitiveness subcommittee of the House Energy and Commerce Committee further probed the Bush administration's decision not to name Japan under the Super 301 provision of the 1988 trade act in a hearing May 10. In response to the subcommittee's request to elaborate on the process leading to the decision, U.S. Trade Representative Carla Hills reiterated many of the points made in her appearance before the Senate Finance Committee April 25 when she testified that it would be counterproductive to cite Japan (see JEI Report No. 18B, May 4, 1990).

Ms. Hills told the panel that the successful completion of the Uruguay Round of multilateral trade talks in December is President Bush's top trade liberalization priority. She emphasized that the United States had made significant progress toward its goal of free and open trade with Japan. As in her testimony before the Senate Finance Committee, Ms. Hills described the administration's four-pronged strategy for creating a competitive market environment with Japan: lower systemic barriers to imports through the Structural Impediments Initiative talks; eliminate sectoral barriers through the statutory authority of Section 301 of the 1974 Trade Act and other means; use the Uruguay Round to negotiate enforceable multilateral trade rules; and build constituencies in Japan that will support market-opening measures. Ms. Hills outlined the progress achieved through each part of this strategy and credited the increasing acceptance of free-trade principles by the Japanese public with facilitating the process. She added that White House confidence in the Japanese government's undertakings has been heightened by this public support.

USTR Hills emphasized that the SII talks had produced concrete commitments from the Japanese to reduce structural barriers (see JEI Reports No. 15B, April 13, 1990, and No. 16B, April 20, 1990). She added that much work remained to be done before the final report is compiled in July, including sharpening commitments from both sides and establishing a credible follow-up mechanism.

In defense of the administration's decision not to name Japan as a priority country this year, Ms. Hills reviewed progress on the three Super 301 cases initiated last year, noting that trade disputes involving access to Japan's satellite, supercomputer and forest product markets had been resolved to the satisfaction of the United States. She added that progress also had been made in opening markets for American-supplied telecommunications products and services (see JEI Report No. 19B, May 11, 1990) and that negotiations were under way to liberalize trade in amorphous metals, a subject of long-standing complaint from Allied-Signal Inc., which claims it has been prevented from marketing the product in Japan (see JEI Report No. 17B, April 27, 1990). She also reviewed the status of attempts to open the construction and the semiconductor industries to U.S. competition.

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JAPAN'S SOCIAL SECURITY AND PENSION SYSTEMS FACE NEED FOR NEW REFORMS

Summary

Like most advanced industrialized nations, Japan has set up a state-run social security system that serves a variety of income-providing and income-leveling functions. But unlike others among its peers, Japan is faced much more quickly with making the leap from a not-so-aged society to one with a tight retiree/worker ratio. Although reforms implemented in 1986 are helping to adjust the benefit system and the related impact on the national budget, further actions have bogged down. Plans to delay the age of retirement and the age at which benefits become available may be in political limbo.

Yet policymakers do not have the luxury of time. The first wave of Japan's baby-boom generation will face retirement in just 15 years or so. Accommodating this hefty chunk of society in retirement could cause more than a ripple effect on the economy. This first generation to benefit from Japan's economic juggernaut has the potential in retirement to disrupt savings rates as well as Japan's fairly equal income distribution.

Between the Rock of Age and a Hard Place

Pension experts, bureaucrats and politicians began voicing concern in the mid-1980s about how Japan was to cope with a rapidly aging society, one in which the group of people aged 65 and over is increasing at a faster rate than the pool of workers aged 15 to 64 (see Tables 1-3). The world's longest life expectancy (81.3 years for women and 75.5 years for men) and a shrinking birth

Table 1: Comparison of Demographic Transition

(percent of population aged 65 or older)

Country	7 Percent	14 Percent	Doubling Time
Japan	1970	1996	26 years
West Germany	1930	1975	45 years
Great Britain	1930	1975	45 years
Italy	1935	1990	55 years
United States	1945	2015	70 years
Australia	1940	2020	80 years
Sweden	1890	1975	85 years
France	1865	1995	130 years

Source: Ministry of Health and Welfare

Table 2: Selected Countries' Dependency Ratio

(population aged 65 and over to working ages 15-64)

Country	1980	1990	2000	2010	2020	2030	2040	2050
Japan	13.4%	16.6%	22.4%	27.5%	33.7%	31.8%	37.5%	37.6%
United States	17.1	18.7	18.3	18.5	25.0	31.7	32.4	31.8
West Germany*	23.4	22.5	25.1	30.3	33.2	43.4	48.8	42.3
France	21.9	21.0	23.1	24.0	30.5	35.9	38.7	37.8
United Kingdom	23.3	23.1	22.3	22.1	25.6	31.3	33.1	30.4
Italy	20.8	20.3	22.9	25.6	28.7	35.3	42.1	37.8
Canada	14.1	16.8	19.0	21.3	29.0	37.2	37.8	36.4

*Excludes impact of proposed unification with East Germany.

Source: Organization for Economic Cooperation and Development, Working Papers: Ageing Populations: Economic Effects and Implications for Public Finance (Paris: 1988), p. 37.

rate (1.66 births per female of child-bearing years in 1988 versus 2 in 1961) are moving Japan toward a potential situation in the early 21st century of having only three workers to support every senior citizen instead of the current six-to-one ratio. Although educational and social welfare costs associated with the young will drop accordingly, the offsets are not expected to be sufficient to balance the increased outlays for seniors' social security, defined in Japan as encompassing a basic benefit, medical insurance and welfare costs.

Both Japan and the United States follow a trust-fund approach to social security, in which contributions made today are supposed to benefit at retirement those who paid them. In reality, the premiums pay current benefits and buy

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Table 3: Japanese Labor Force by Age, 1981-88*

(in millions)

	15-24			25-39			40-54			55-59**			60-64			65 and Up		
Year	Labor Force	Number Working	Outside Force	Labor Force	Number Working	Outside Force	Labor Force	Number Working	Outside Force	Labor Force	Number Working	Outside Force	Labor Force	Number Working	Outside Force	Labor Force	Number Working	Outside Force
1981	7.00	6.72	9.02	21.46	21.01	7.07	19.18	18.91	4.79	9.44	9.17	11.93	--	--	--	--	--	--
1982	7.02	6.71	9.13	21.32	20.86	6.83	19.64	19.33	4.75	9.75	9.47	12.39	--	--	--	--	--	--
1983	7.29	6.96	9.17	21.26	20.73	6.55	20.13	19.75	4.63	10.21	9.89	12.72	--	--	--	--	--	--
1984	7.34	6.98	9.37	21.02	20.49	6.41	20.48	20.10	4.62	4.75	4.59	2.01	2.74	2.61	2.37	2.95	2.90	8.94
1985	7.33	6.98	9.70	20.98	20.46	6.37	20.56	20.20	4.60	4.88	4.73	2.05	2.88	2.74	2.47	3.00	2.95	9.31
1986	7.54	7.16	9.88	21.14	20.61	6.32	20.46	20.10	4.53	4.98	4.81	2.13	3.05	2.90	2.60	3.02	2.98	9.68
1987	7.65	7.24	10.21	20.85	20.31	6.06	20.85	20.44	4.61	5.14	4.96	2.13	3.22	3.05	2.73	3.12	3.09	10.10
1988	7.82	7.44	10.47	20.30	19.82	5.81	21.62	21.26	4.61	5.28	5.13	2.16	3.37	3.21	2.87	3.26	3.22	10.43

*The labor force is characterized as all employees eligible or wanting to work. The number working includes self-employed workers who have not been absent from work for more than 30 days.

**Includes all those over the age of 55. Further detail from 1984 on was made available on older workers in the 1988 Yearbook of Labor Statistics.

Source: Ministry of Labor, Yearbook of Labor Statistics, 1985 and 1988.

government securities that, when they come due in the future, will cover payments for that generation of senior citizens. Now being debated in the United States is whether the premiums set by the 1983 revisions to the Social Security Act are creating an unnecessarily heavy burden on current workers by generating more money than is needed to pay present benefits and, in the process, encouraging the government to use the surplus to fund other programs as well as fueling high government debt that will have to be redeemed by future generations.

In Japan social security payments as well as premiums paid into the government-run pension program generally enter trust fund accounts used to build infrastructure and various other projects under the Fiscal Investment and Loan Program. The debate there is whether a better return could be achieved bypassing the Ministry of Finance's trust fund, which pays 5.1 percent, and investing more of the contributions in private-sector investments that offer a current return of about 9.1 percent.

Fears about the drain on the general account budget, which covers roughly a third of basic benefits (see Tables 4-5), are leading to questions like:

Table 4: Public Pension Expenditures in Japan and the United States and Share of GDP, 1975-85

(in billions of yen* and millions of dollars)

Country	1975	1977	1979	1981	1983	1985
Japan**						
Expenditures	Y3.89	Y6.59	Y8.98	Y12.05	Y14.39	Y16.89
Share of GDP	2.6%	3.6%	4.1%	4.7%	5.1%	5.3%
United States***						
Expenditures	$105.97	$131.88	$162.56	$215.64	$255.30	$285.20
Share of GDP	6.7%	6.7%	6.6%	7.2%	7.6%	7.2%

*The yen figures can be converted into dollars at the following average annual exchange rates: 1975, Y305.15; 1977, Y240.00; 1979, Y239.70; 1981, Y220.54; 1983, Y237.51; and 1985, Y238.54.

**Includes national pensions, seamen's insurance and mutual benefit association pensions, pension funds, welfare pensions, civil service pensions as well as compensation for civil service casualties and other casualties, including the nonmedical aspects of workmen's compensation, except for that associated with suspension from work.

***Includes old age, survivor's and disability insurance (also known as social security), federal civilian and military pensions, railroad retirement, veterans' pensions, disability and life insurance benefits, state and local pensions and supplemental security income as well as benefits for black lung disease.

Source: Organization for Economic Cooperation and Development, Annual National Accounts (Paris: various years), and Social Data File, Reforming Public Pensions (Paris: 1988), pp. 140-141.

Table 5: Social Security* Outlays in Japan and Contributions, 1979-87

(in billions of yen**)

Year	Outlays	Contributions	Percent
1979	Y21,801	Y16,049	73.6%
1980	24,169	17,513	72.4
1981	27,164	20,072	73.9
1982	29,665	21,646	73.0
1983	31,647	22,896	72.3
1984	32,945	24,270	73.7
1985	34,918	26,185	75.0
1986	37,551	27,767	73.9
1987	40,331	29,765	73.8

*Includes all types of public pensions, health insurance and other welfare payments.

**The yen figures can be converted into dollars at the following average annual exchange rates: 1979, Y239.70; 1980, Y226.74; 1981, Y220.54; 1982, Y249.08; 1983, Y237.51; 1984, Y237.52; 1985, Y238.54; 1986, Y168.52; and 1987, Y144.64.

Source: Economic Planning Agency, Annual Report on National Accounts.

what degree of income support should senior citizens receive and at what age should the older worker be encouraged to retire. Even more complex are such issues as whether unfolding demographic and societal changes will upset components of Japan's economic miracle, such as the country's high savings rate, and an employment system based on seniority.

Adjustments to a Maturing System

Reforms to the government-operated social security and retirement system went into effect in April 1986. The Organization for Economic Cooperation and Development said that among its member countries "the Japanese reform probably constitutes the most radical reform of public retirement provisions to have been attempted in the last decade."[1] By the mid-1980s Japan's immature state-run program was paying out substantially more to those who were retiring than they had contributed. (Pension expert Kiyoshi Murakami blames this partially on many elections' worth of campaign promises that ignored the need to adjust contribution rates.) The increases presented little problem in a booming economy where contributors substantially outweighed recipients. However, after a good look at the baby-boom bulge making its way through the system, policymakers engineered changes. These addressed not only a reduction in benefits per contributions but the plight of women who had not entered the work force and might not be counted as eligible for a spouse's benefits (through divorce, for example).

[1] Organization for Economic Cooperation and Development, Reforming Public Pensions (Paris: 1988), p. 112.

Basic Benefits - The nonmedical portion of the social security system, which previously left many elderly with no other income support than their own resources, covers all residents, usually at age 65. Moreover, all residents between the ages of 20 and 60 must participate (although exclusions are allowed under some circumstances). Whether a person is self-employed, works for a company, belongs to a mutual-aid association, such as those covering railroad workers, or even is outside the work force, he or she now pays into the national pension scheme (kokumin nenkin) and is eligible to receive a basic benefit.[2]

Unlike the American system, which requires the self-employed to pay premiums equal to the percentage paid by both employer and employee (15.3 percent of applicable earnings in 1990), the independent worker in Japan pays the same flat portion that others do, currently about Y8,300 a month ($55.33 at Y150=$1.00). A working spouse covers his or her partner's contribution; an employed parent might contribute for a 20-year-old child who is not working. Those unable to pay premiums still are eligible for benefits as a result of the pooled resources to which the government adds one-third. In December 1989 the Diet increased premiums about 2 percent and benefits about 6 percent. Monthly benefits, always paid out in the form of an annuity, currently amount to Y55,500 ($370) for a person who has contributed for 40 years (proportionately less for fewer years of participation).

Employees' Pension Insurance - Covered by a second tier of benefits are employees earning wages or salaries. An estimated 28 million of the 60 million workers in Japan fit this category and participate in the government-run employees' pension insurance scheme (kosei nenkin). While participation is mandatory for incorporated firms, the program is optional in several industries, usually those that are service-related. On top of paying the flat-rate premium for the social security benefit (and covering any nonworking family members), an employee matches contributions with his or her employer at a current rate of about 6.2 percent of monthly remuneration, which excludes bonuses. (The rate for women currently is 6.05 percent, but by 1993 the two rates are to converge.) The employee's contribution to the EPI fund is not taxed until benefits are paid out; employers can deduct premiums as a business expense.

As a carryover from the days when 55 was the accepted retirement age -- which it still is for many firms -- a 60-year-old retiree can start to receive EPI benefits. (Under the 1986 reforms 55-year-old women could begin getting payments, but by the year 2000 the eligible age for both sexes is expected to be uniform.) A current major debate is whether Tokyo will be able to boost the eligible age for pension benefits to 65. Labor unions are among those opposed

[2] Just like the old age, disability and survivor's insurance provided under America's social security system, Japan's basic benefits include not only an old-age benefit but disability payments available to qualifying persons aged 20 and up and a survivor's pension. Even though Japan's constitution recognizes equality of the sexes, the survivors' pension is specified for a widowed mother or bereaved children. For the survivors and those not totally disabled the monthly payment in 1988 was Y52,208 ($348 at Y150=$1.00), although the surviving widow could receive Y15,658 ($104) each for up to two children and Y5,225 ($35) for each additional child.

to the delayed payout, particularly since the average retirement age is currently 62 (see JEI Reports No. 44B, November 17, 1989, and No. 11B, March 16, 1990).

Instead of channeling EPI contributions into the government's pension fund, which is run by the Ministry of Health and Welfare, large corporations can make tax-deductible contributions to a privately run, nonprofit company set up solely to manage the EPI monies. These firms are called kumiai. Participating companies, instead of contributing the EPI rate of 6.2 percent of a worker's basic salary, are allowed a lower rate of about 4.5 percent, matching the contributions of employees. These funds are among those that are not subject to the 1 percent tax levied on special corporate pension funds. As of March 1989 more than 7 million workers reportedly participated in 1,259 such MHW-approved trusts.

Other Pension Plans - Company pension plans, known generically as kigyo nenkin, may or may not have tax advantages. Of the type that does, tax-qualified pension plans (tekikaku nenkin) are popular with medium-sized firms. Out of an estimated 71,000 such plans in 1987 approximately 56,000 were established by companies with fewer than 100 people. The plans' popularity in part stems from their ability to offer a way to gain a tax advantage for the most widely used form of Japanese retirement benefit, the lump-sum payment. For the most part, contributions come solely from the company. (Less than 2 percent of the plans in 1980 reportedly took employee contributions.)

Premiums in the past could be handled only by insurance or trust companies, but recent changes have broadened the range of financial institutions that can invest the money (see below). However, the firms assigned to handle the pension funds pay a 1 percent tax on the money they earn each year. Both Keidanren (Japan Federation of Economic Organizations) and Nikkeiren (Japan Federation of Employers' Associations) have called for the tax to be dropped to encourage more small firms to adopt pension plans. Branches of the Ministry of Finance and the Ministry of Labor jointly oversee tax-qualified pension plans.

These company plans typically pay retirement benefits either in the form of a lump sum, a fixed-term annuity (of about 10 years) or a combination of both. Due to the limited term of annuities, many employees opt for a simple one-time payment to get control of the funds immediately. Special tax breaks for lump-sum payments also make this option attractive.

Another type of company plan has no pension-related tax advantages but can be used for retirement benefits at the firm's discretion. Since a company-provided pension is not universally mandatory (except as noted above), some companies use a retained-profits reserve to fund pensions. Since these payments do not need to follow antidiscrimination and other rules established under tax-qualified plans, some firms prefer this flexibility.

Premium/Benefit Adjustments

Two major changes made by the 1986 reforms involved an adjustment of EPI premiums and a realignment of retirement benefits to past salary. At the end of 1988 the Diet enacted a 3 percent consumption tax also with the intent of preparing for a future when fewer workers would be supporting more retirees, who, in turn, would be paying lower income taxes.

- Premiums - To avoid overburdening future generations of workers, which under the old government pension system faced a projected employer/employee premium rate of 38.8 percent of monthly remuneration in the year 2025, the now-anticipated EPI contribution rate in the year 2025 would be 28.9 percent, of which employers and employees would pay half. If a proposal to delay pension eligibility until age 65 receives approval in the future, the combined premium could drop to 23.9 percent. Even that rate -- nearly double the current tax -- would be stiff. Whether future legislators will endorse the increases will depend on the alternatives, including whether to keep annuity-style benefits at their current level of about 68 percent of a worker's base salary. This figure, which does not include bonuses, averages the career earnings of an employee and adjusts for inflation.

- Benefits - Prior to the 1986 reforms the government pension program was geared to provide the average worker with a dependent wife after 40 years of work with 83 percent of his gross monthly remuneration, a figure that averages standard (nonbonus) wages or salaries over the entire time the beneficiary has paid into the system and adjusts for inflation. That rate, as noted, now stands at about 68 percent, although the decision to provide separate social security-style benefits for dependents (who now can draw a check if they are disabled or divorced) complicates a direct comparison of the rates.

Mr. Murakami, who serves on several government pension advisory panels and is an adviser to Nippon Dantai Life Insurance Co., Ltd., estimates that the monthly pension benefits paid to an average male retiree with 35 years on the job is about Y190,000 ($1,300), or roughly 68 percent of his monthly remuneration (see Table 6) when combined with the basic social security payment. The earnings-related portion from the employees' insurance pension program comes to about 30 percent of a worker's average career earnings, the pension expert said. However, given that the twice-a-year bonuses paid by most big corporations are not figured into the calculation, Mr. Murakami suspects that pension

Table 6: Japanese Companies' Annual Employee Pension Costs, FY 1981-FY 1988

Fiscal Year	Number of Businesses	Insured Employees	Monthly Average Remuneration (in yen)	Lump-Sum Payments (in millions of yen)	Pension Payments (in millions of yen)
1981	985,751	25,584,651	Y198,288	Y1,115.7	Y4,280,813.0
1982	1,000,788	25,906,815	207,253	1,207.3	4,855,942.7
1983	1,010,787	26,230,929	213,041	1,225.9	5,310,923.8
1984	1,020,560	26,619,915	220,350	1,150.4	5,898,344.0
1985	1,029,992	26,942,296	231,566	1,194.1	6,652,034.2
1986	1,049,799	26,720,238	237,166	1,451.1	7,906,084.6
1987	1,104,675	27,437,017	241,391	999.6	8,582,981.8
1988	1,207,141	28,445,483	248,712	997.2	8,940,507.8

Note: The yen figures can be converted to dollars at the following average fiscal year exchange rates: FY 1981, Y227.52; FY 1982, Y249.64; FY 1983, Y236.33; FY 1984, Y244.19; FY 1985, Y221.09; FY 1986, Y159.84; FY 1987, Y138.35; and FY 1988, Y128.26.

Source: Social Insurance Agency

checks come to roughly 50 percent of yearly salary.[3] Yet, since these calculations are based on gross income, Mr. Murakami contends that pensions (including social security) actually replace almost 80 percent of net income, after deducting for differences in income taxes and health costs, among others.[4] (In 1985 social security was expected to replace 63 percent of the income received by an American earning minimum wage.)

These figures do not include the lump-sum retirement payment popular in Japan, which forms about 90 percent of the benefits paid out of tax-qualified pension funds, according to Mr. Murakami.[5] Lump-sum payments often go for a variety of purposes other than income maintenance, such as paying for children's advanced education or weddings (a considerable expense if traditional form is followed). Of course, if the educated or married child supports the parent in retirement, this, too, could count as income. Paying off the home mortgage is another popular use of the lump-sum payment. All three uses mirror the relatively early retirement encouraged by companies in Japan since these are costs associated with maturity and not necessarily old age. Future attempts to adjust the pension system will look at the retirement age along with a variety of other alternatives.

Looking Ahead to Further Change

Governments trying to balance the income needs of senior citizens with a shrinking labor pool typically look at hiking the retirement age, which achieves a double goal of alleviating an employment crunch (at least nominally, if that problem exists) and increasing the years of contributions to the funding vehicle. Another option is reducing social security benefits (and/or, in Japan, EPI pension payments), which challenges assumptions about how much support the government is expected to give senior citizens to ward off poverty even at the cost of other programs. This option brings into play, too, how much workers should be saving for retirement, either on their own or through company pension programs. Additionally, policymakers are questioning how much of the elderly's income needs they can shift to private enterprise. Raising premiums is another way governments can assure a flow of funding for income security.

Tinkering with Retirement Ages - The government's push has been all uphill to raise the retirement age from the traditional 55 to age 60, which is the age at which the majority can receive pensions under the EPI scheme, either through the government or the private-operated version. According to a July 1989 Ministry of Labor survey, 86.4 percent of Japan's large companies have adopted this retirement age, while 61.2 percent of the firms that employ fewer than 100 workers have done so. Thus, the total number of firms with an official age of 60 for retirement climbed 3.1 percentage points from the previous year, the ministry said. Further efforts to set age 65 as the new gold-watch milepost continue to run into problems (see JEI Report No. 11B, March 16, 1990).

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[3] Kiyoshi Murakami, "When I'm Sixty Five?" Look Japan, February 1990, p. 8.

[4] Kiyoshi Murakami, "Aging and Pensions in Japan." Paper presented at the "Aging in Japan: Lessons for the U.S.?" forum sponsored by the Employee Benefit Research Institute and the Population Reference Bureau, Washington, D.C., July 26, 1989.

[5] Ibid.

Some observers contend that the ruling party's loss of its upper house majority in the July 1989 elections means that reform of the retirement age will be delayed as much as six years (at which time the other half of the seat-holders in the upper house will have stood for election). Of course, if the Liberal Democratic Party regains control earlier (see JEI Report No. 20B, May 18, 1990), the retirement question could get quicker action. Labor groups, however, usually staunch allies of the opposition parties, tend to support the advanced retirement age (in contrast to their opposition to a higher age for benefit eligibility), while the LDP's business allies oppose legislated retirement ages.

Ironically, while the government pushes for the higher retirement age, some large companies are considering pushing their employees toward the door even earlier to open up more top management slots.[6] (A similar dichotomy appears in the United States. Many American firms are using early retirement offers to retrench and consolidate operations, while reforms to the Social Security Act postpone the availability of full benefits to age 67 -- instead of the current 65 -- for those who turn 62 after the year 2022.)

Increasing the retirement age ostensibly could help offset a labor shortfall in Japan, a gap projected by the International Labor Organization at 2.7 million workers 10 years from now. However, older, experienced workers may not fit the bill; the typical call is for young, mentally and physically agile male workers for whom the job-to-applicant ratio in late 1989 was 2.11 versus 0.24 for those over age 55. And, whether voluntarily or not, Japan's 65-and-older male workers are decreasing in number. In the 1960s over half continued to work but in 1985 only 37 percent did. Among women the decline was less, but it started from a lower base of 25.6 percent working after age 65 in the 1960s and dropped to 15.5 percent continuing to work in 1985.

The company-oriented attitude of Japanese "salarymen," which make up only about one-third of the working population, means that job security and seniority-based wage increases have their limits if the firm is to remain competitive. Thus, to avoid being locked into higher salaries for older workers, companies have taken to holding the line on increases, according to one research institute. Roumu Gyousei Kenkyusho (Labor Administration Research Institute) estimated that 20 years ago a 55-year-old employee who had been working for a company for 33 years received about 4.68 times what a new employee did. That rate now is 3.56, the institute reported.[7] At a 1989 forum on the problems of aging in Japan David Crawford of Wyatt Co., an employee and actuarial consulting firm, noted, "In fact, companies are dealing with the age shock in their work forces by restructuring their pay systems away from the seniority principle and towards some basis related to performance. It is most often a gradual process but the direction is clear: older workers will not enjoy higher pay simply because they are older." He cited Nippon Steel Corp. as an example of a company that had revised merit-to-seniority-pay ratios from 50-50 to 60-40 in

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[6] "Big Companies: Retirement at 50," Business Tokyo, February 1990, p. 7.

[7] "Labor Letter: Competence Ousts Seniority," Wall Street Journal, March 14, 1989, p. 1.

1988 with no pay raises tied to seniority for managers above the middle-management level.[8]

Managers who want to keep working may even be encouraged to leave early if their corporation makes arrangements for them to transfer to good jobs in affiliated companies. Others who want to keep working might be rehired at less pay for the same amount of work. MOL's 1989 white paper noted that about 80 percent of the 2.76 million retirees in the 60-64 age bracket continued to work for a few more years under special programs.

The Labor Ministry's FY 1990 budget includes an increase for its program to give companies monthly incentives to hire workers over the age of 60. Under the plan a company with more than 6 percent of its work force in the 60-65 age span can receive Y30,000 to Y40,000 ($200 to $267) for each worker, depending on the size of the company. MOL also provides assistance to retirees looking for new jobs.

A review of the government's policies toward retirement and the leisure/work opportunities for those over 65 is the task of an advisory committee appointed in late 1989 by Prime Minister Toshiki Kaifu. Similar to one set up by his mentor, the late Prime Minister Takeo Miki, the Committee on Japanese Society in the 21st Century is to look at the long-term funding possibilities for senior citizens' income. A report released in April by the Provisional Council for the Promotion of Administrative Reform (see JEI Report No. 17B, April 27, 1990) called for further reforms of the social security system, such as expanded medical and basic income benefits, as well as actions to address the discrepancy in a system where a flat-rate benefit is provided all elderly but only some workers get pensions. The panel urged equitable sharing of retirement financing among generations and recommended that an individual's combined national (including social security) and local taxes be no higher than 40 percent of gross income by 2000 and 50 percent by 2020.

Lowering Benefits - A major concern in establishing generational equity is whether decreased support for the elderly would thrust them into poverty and, conversely, whether increased help would pose problems to the young. Since those over age 70 pay relatively little for medical care under Japan's system of health insurance (see JEI Report No. 16A, April 21, 1989), they currently avoid one of the highest costs facing older people. The country, however, pays. In 1980, for example, the 9 percent of the population aged 65 and older accounted for 27.4 percent of the government's medical expenditures. (For more information about the economic costs of social welfare in Japan, see JEI Report No. 12A, March 27, 1987.)

Observers of Japan's booming economy wonder whether those growing up now in relative affluence will demand more benefits and seek more leisure activities in their retirement years than do those who remember the struggles of the postwar years. People with land in populated areas certainly have benefited

[8] David Crawford, "The Impact of Aging and Cultural Changes on Pensions in Japan and Its Relationship to the U.S." Paper presented at the "Aging in Japan: Lessons for the U.S.?" forum sponsored by the Employee Benefit Research Institute and the Population Reference Bureau, Washington, D.C., July 26, 1989.

from the surge in land prices. But not all Japanese own their homes, and the number who do dropped from 62.4 percent in 1983 to 61.1 percent in 1988 (see JEI Report No. 30A, August 4, 1989). The young are particularly hard hit by the rising cost of housing, as indicated by the fact that only 17.8 percent of those aged 25 to 29 owned homes in 1988 compared with 27.9 percent of people now aged 50 to 54 who owned their homes by the time they reached age 29.

Home ownership rates and other statistics indicate that the majority of Japanese who already have retired may not face dire poverty if benefits were to be adjusted. However, changes in Japan's social fabric threaten new wrinkles, including the declining number of elderly who live with their children and the increased number of mature women in the work force. In 1970 approximately 70 percent of the population over age 65 lived with their children. A 1988 Ministry of Health and Welfare survey showed that percentage down to 61.9 percent, although it was noted that almost one-fourth of Japanese families live with a person aged 65 or older. The larger number of working women means fewer are at home to care for the aged, which potentially could increase the numbers of elderly living in retirement settings. Of course, if grandma and grandpa own the home and their children rent elsewhere, the younger generation may be willing to make accommodations in living arrangements.

Other MHW figures show that people over age 65 were relying more heavily on social security payments and retirement benefits than savings or other earnings in the mid-1980s than was true for their counterparts between 1975 and 1981. By 1984, for example, social security and retirement benefits counted for 56.9 percent of the elderly household's gross income compared to 34.3 percent in 1975, when savings and salaries/wages made up 56 percent of the total (versus 34.5 percent in 1984). Policymakers have to address the question of whether cutting back on benefits would be fair to workers who have begun to expect them. A survey done by the Prime Minister's Office and released in March 1990 indicated that of the 3,800 or so men and women aged 30 and over who responded, more than half (61.4 percent) are pessimistic about the solidity of Japan's welfare system, which includes basic social security benefits, pensions and health care. Nevertheless, 62.8 percent said they want the safety net for senior citizens increased. A full 70 percent want to continue working in their old age.

A 1989 study for the OECD suggests that the social security and pension rates paid by current workers and their employers could drop as much as 5 percentage points if Japan calculated benefits on the basis of net rather than gross wages with a gradual increase in the retirement age.[9] Mr. Murakami has noted that the switch to a net income-based benefit level would counter a potential situation in the year 2020 in which "active employees (typically [a] four-member family) and retired persons (usually husband and wife) will receive the same amount" of adjusted take-home pay if the combined employer/employee contribution rate jumps to 30 percent.[10]

[9] Alan J. Auerbach, Laurence J. Kotlikoff, Robert P. Hagemann and Giuseppe Nicoletti, "The Economic Dynamics of an Ageing Population: The Case of Four OECD Countries." OECD Economic Studies No. 12, Spring 1989, pp. 76-77.

[10] Murakami, "Aging and Pensions in Japan," op. cit.

The Role of Savings

The relative youth of Japan's old-age insurance system (which did not cover a variety of workers until passage of the 1959 National Pension Act) often is used to explain Japan's high savings rate. In fact, even the Economic Planning Agency contends that the growth of the social security system and the spread of pension programs are responsible for trimming the household savings rate (see Table 7). The agency estimates that the increased number of elderly will eat into the household savings rate even more, helping push it toward about 11 percent of disposable income in the year 2000. This would be good news to Americans who complain that Japan's high savings rate is one of the barriers to increased consumption (and, thus, imports).

Table 7: Japan's Household Savings Rate, 1967-88

(percent of disposable income)

Year	Savings Rate	Year	Savings Rate
1967	13.5%	1978	20.8%
1968	15.8	1979	18.2
1969	15.6	1980	17.9
1970	17.9	1981	18.3
1971	17.8	1982	16.5
1972	18.2	1983	16.3
1973	20.4	1984	16.0
1974	23.2	1985	16.0
1975	22.8	1986	16.4
1976	23.2	1987	15.1
1977	21.8	1988	14.8

Source: Economic Planning Agency

However, an annual government survey indicated that the amount of new savings in 1988 achieved by those over age 65 was only 11 percent less than the average of all households (about Y240,000 or $1,597). And a 1988 survey by the Ministry of Posts and Telecommunications revealed that 70 year olds had the largest piggy bank, which, including investments in insurance and negotiable securities, averaged nearly Y14.8 million ($98,500). MPT calculated that the elderly need close to Y23.9 million ($159,000) in savings on average to feel financially secure with annual living expenses estimated at Y3 million ($19,867). Survey responses showed a Y14 million ($93,300) shortfall for the average family, although MPT, which runs the postal savings system, has obvious reasons to promote savings.

Whether savings actually drop in countries that assure basic incomes for senior citizens, and whether that assurance is the reason, remain open to debate. In the aggregate, however, social security and pension trust funds reflect savings for a country as a whole. Obviously, Tokyo is hoping to create a large pool capable of handling its wave of baby boomers.

Using Tax Policy to Shore Up Support

A 3 percent consumption tax went into effect in April 1989 along with associated changes in the personal income tax structure to help avert a funding crisis as a larger population of elderly draws more income support from the government. Had Tokyo continued to rely on personal income taxes as a main source of general account revenues, the average retiree would have paid very little into the state coffers. For example, a lump-sum "termination" payment is tax-free up to Y15 million ($100,000) for a 30-year employee and up to Y22 million ($146,700) for a 40-year employee.

The personal income tax reforms meant that the number of brackets for the national tax dropped from 15 in FY 1986 to five and that the top rate was 50 percent rather than 70 percent. Also, the elderly were allowed to retain tax exemptions on certain types of savings accounts, while most others lost that benefit. Thus, the tax bill of an increasing percentage of the population would have decreased while the government's need for revenue grew to pay for the gap between social security and pension contributions and payments.

The consumption tax, while regressive, was designed to raise more money than the commodity and other taxes it replaced. Retirees, who would be expected to cut back on consumption as they left the work force, would pay only on the same basis as other age groups. And, while the ranks of senior citizens swelled and theoretically shrunk income tax payments from this segment of the population, older people still would face the same consumption tax, thus sustaining a source of funds for government social security and pension obligations.

Other tax incentives encourage company funding of private pension plans. As mentioned earlier, Keidanren and Nikkeiren have suggested that the abolition of the 1 percent tax on income from company-funded pension plans would result in more small companies offering coverage. While Tokyo looks at such suggestions, policymakers also are considering how to make the money already in the government's trust funds work better for them since the interest earned on social security and pension contributions can offset the amounts needed for future payments.

The Perils of Pension Fund Management

A piggybank valued at Y62.6 trillion ($417.2 billion) is not taken lightly -- and that is how much money had been collected in social security taxes and payments to the government's employees' pension insurance plan as of March 31, 1988. But when the interest on this money amounts to 5.1 percent, some pension experts begin to question whether more flexibility should be allowed in managing the trust funds. Evidence of the debate over how to invest the money was veiled in a mid-June 1989 article in Nihon Keizai Shimbun, which noted that the Ministry of Health and Welfare had achieved 1.5 percentage points more interest on its management of a Y4.1 trillion ($27.5 billion) public pension fund in FY 1988, for a total of Y60.6 billion ($404 million), than had the Ministry of Finance on a pension fund managed by its Trust Fund Bureau. MHW has suggested it would like to see as much as one-third of social security and EPI payments privately managed in hopes of gaining returns of at least 9.1 percent a year.[11]

[11] "Taking the Lid Off Japan's Pensions Pot," The Economist, February 4, 1989, p. 73.

A first step in opening the large corporate-sponsored pension business to competition came last December when the Diet removed the limits that had allowed only insurance companies and trusts to manage these funds, estimated at the time at Y19.6 trillion ($130.7 billion). Jumping to the challenge were 133 investment advisory firms, including 36 foreign companies. Some experts worry, however, that traditional insurance and trust firms will retain most of the business because of the absence of a system to rate the performance of the new pension fund managers. What may worry people approaching retirement, however, is whether their funds will be safe. Japan lacks a mechanism to ensure fiduciary responsibility.[12]

Outlook

Japan's reforms of its social security system and the government-run pension program and its encouragement of corporations to institute their own pension plans have set the stage for a comfortable retirement for the first wave of baby boomers, heading for 65 by the year 2011. But the increasing demands on the working population as more and more senior citizens drain money from the system mean that additional changes are necessary. Among those likely are a uniform age of 65 (and possibly older) for retirement and the same standardized age for eligibility to receive payments from the government-operated pension plan. Also possible are revisions that base benefits on net rather than gross remuneration and that continue increases in the contribution rate for working persons, including an earnings-indexed contribution for basic social security benefits. While private pension fund managers hope that Japan's economy continues to generate steamy investment profits, Tokyo will be eyeing how much leeway to give for investing public trust funds.

All these policies will have to mesh with plans to continue relying on domestic demand to move the economy forward. This, in turn, requires savings and investment from households and companies, respectively. If either feels constrained by retirement policies -- for example, if companies lose their flexibility in reassigning management or are required to retain workers that no longer are aggressive in formulating or adapting to new technologies -- the economy could lose two of its traditional generators. Tokyo's time is running short, however, to move toward policies that help keep pensioners, companies and the public trust funds solvent.

For more information, contact Pat Murdo.

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The views expressed in this report are those of the author and do not necessarily represent those of the Japan Economic Institute.

JEI Report will not be published June 1, 1990 because of the Memorial Day holiday. The next issue will be dated June 8, 1990.

[12] Saburo Kobayashi, "Employee-Sponsored Pension Systems in the United States and Japan," US-JP Occasional Paper 87-03, Harvard University Program on U.S.-Japan Relations, p. 18.

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REPORT

A Two-Part Report: A and B

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IN THIS ISSUE:

Yen Creeps Back Up 1

Washington Ups Ante In Financial Talks 3

New Land Taxes May Be Proposed By Autumn 6

Roh Visit Highlights Thorny Issues
In Japan-South Korea Relations 7

New Tied-Aid Initiative Announced 9

Notes: Bid-Rigging Measures 11

Yen Creeps Back Up

Subtle discipline is sometimes the most effective way to exert one's will on a child -- or foreign exchange markets. Although some child psychologists and experts in international finance might dispute such a conclusion, finance ministers and central bankers of the Group of Seven industrial nations might be among the believers in the aftermath of a May 6 meeting in Washington. In contrast to an apparently contentious April meeting, after which the yen moved little against the dollar, the quieter May session led to a long-awaited surge in the value of the Japanese currency.

At the earlier G-7 meeting Finance Minister Ryutaro Hashimoto reportedly carried an urgent message to his counterparts: the yen was in trouble along with the Japanese stock market (see JEI Report No. 15B, April 13, 1990). At the time the Japanese currency was trading at its lowest level in more than three years, and the stock market uncharacteristically had been dropping for three months. While the subsequent communique mentioned the undesirability of a weak yen, most press reports suggested Mr. Hashimoto's colleagues generally turned a deaf ear to his plea for support. The meeting followed repeated but mostly apparently soothed the European feathers ruffled as the IMF struggled to make room for Japan near the top of the list.

With the latest reshuffling the United States and Japan dominate the top ranks of contributors to both the IMF and its sister institution, the World Bank. An American traditionally heads the World Bank and a European, the IMF. The next debate over relative influence in the two organizations could coincide with the 1992 expiration of the term of the current IMF managing director, Michel Camdessus of France. Some reports suggest that Tokyo would like a Japanese national to replace Mr. Camdessus, a move that would appear to be a logical extension of the latest quota allocation. European nations, feeling a burst of regional pride as a result of their expected 1992 economic integration and the worldwide focus on Eastern Europe, are not likely to be enthusiastic about such an initiative. In the long run imposing discipline on the yen and other currencies is likely to be child's play compared to curbing the sibling rivalry among the leading industrial countries.

Douglas Ostrom

Washington Ups Ante In Financial Talks

In a bid to stave off congressional retaliation the Bush administration pushed hard for broader liberalization of Japan's financial markets during a May 21-22 meeting in Tokyo of the U.S.-Japan Working Group on Financial Markets. In essence, Under Secretary of the Treasury for International Affairs David Mulford urged Tokyo to adopt a hands-off attitude toward domestic financial markets, letting the forces of supply and demand reshape market structures and allowing foreign firms to freely peddle innovative products in Japan. The Japanese delegation, led by Vice Finance Minister for International Affairs Makoto Utsumi, was prepared with responses to the numerous American suggestions but made it clear that liberalization will proceed in a careful and gradual manner. The agenda of the two-day meeting covered four broad areas:

- Deregulation of deposit interest rates - The Bush administration recognizes that the Ministry of Finance has taken important steps toward deregulating interest rates paid on deposits but wants the process to be accelerated and a definite timetable set for complete deregulation. The Finance Ministry pointed out that a majority of savings deposited with banks is already in free-market instruments (see Table). Nevertheless, MOF hinted at a tentative schedule for deregulating by 1993 interest rates paid on all time deposits. The Ministry has a three-pronged plan of attack: lowering the minimum amount for large-lot time deposits, which offer freely changing market returns; lowering the minimum size of small-lot money market certificates, which offer a fixed rate of return linked to market rates; and introducing a new instrument this fall that will offer a return indexed to market rates but capped at some level. MOF is facing stiff opposition to the introduction of the new type of money market certificate from small regional banks and credit associations that fear it will put severe pressure on their profit margins. Not only is the cost of raising funds higher but the cost of administering deregulated instruments is higher than for fixed-rate time deposits. The interest rate cap is a concession to these smaller institutions, but MOF is determined to expose all Japanese deposit takers to the discipline of market forces.

Trends in Market-Rate Bank Deposits in Japan

(in billions of yen and percentage share)

		Market-Rate Deposits						
	Total Deposits*	Large Time Deposits	Money Market Certificates	Non-Residents' Yen Deposits	Foreign Currency Deposits	Certificates of Deposit	Total	Market-Rate to Total Deposits
1975	Y92,921.3	--	--		[Y2,591.7] 100.0%	--	Y2,591.7 100.0%	2.8%
1980	152,978.3	--	--	1,137.9 11.8%	6,577.0 68.2%	1,931.1 20.0%	9,646.0 100.0%	6.3
1981	171,418.5	--	--	1,260.0 10.7%	7,863.0 66.7%	2,674.0 22.7%	11,797.0 100.0%	6.9
1982	183,576.8	--	--	1,337.0 9.6%	8,953.1 64.5%	3,581.1 25.8%	13,871.2 100.0%	7.6
1983	199,507.9	--	--	1,349.3 7.7%	11,622.8 66.1%	4,612.4 26.2%	17,584.5 100.0%	8.8
1984	218,242.0	--	--	1,987.9 8.6%	13,934.4 60.2%	7,210.7 31.2%	23,133.0 100.0%	10.6
1985	238,581.5	Y4,598.4 12.1%	Y5,095.5 13.4%	2,413.7 6.3%	18,021.5 47.3%	7,979.6 20.9%	38,108.7 100.0%	16.0
1986	258,948.5	16,267.4 30.5%	8,028.6 15.1%	1,783.6 3.3%	18,744.3 35.2%	8,445.8 15.9%	53,269.7 100.0%	20.6
1987	284,623.3	43,515.2 47.0%	15,113.4 16.3%	2,018.2 2.2%	22,877.4 24.7%	9,151.4 9.9%	92,675.6 100.0%	32.6
1988	358,337.8	80,367.6 54.6%	26,145.4 17.8%	2,103.7 1.4%	23,213.6 15.6%	15,368.6 10.4%	147,198.9 100.0%	41.1
1989	405,502.3	152,628.7 66.0%	30,521.9 13.2%	2,100.5 0.9	25,608.7 11.1%	20,393.3 8.8%	231,253.1 100.0%	57.0

*Deposits from all sources plus certificates of deposit.

Source: Bank of Japan

A particularly thorny problem, however, is how to deregulate rates paid by the giant postal savings system. If the rates are competitive with those offered by the nationwide commercial city banks, the postal savings network would overwhelm small, local banking institutions; if they are restricted to preserve these operations, the postal savings system will be uncompetitive in areas where the nationwide and regional banks operate. Bankers want some limits on the postal system since it is, in some ways, larger than their entire industry. As an example of its competitive ability the postal savings network recorded about Y4 trillion ($26.7 billion at Y150=$1.00) worth of new small-lot MMCs on April 2 when a lower minimum size went into effect, dwarfing the amount registered by its nearest competitor, Sumitomo Bank, Ltd.'s Y86 billion ($573.3 million).

- Foreign access to Japanese financial markets - The U.S. negotiating team attacked the various legal and administrative partitions that prevent foreign financial firms from freely participating in whichever Japanese market they may desire. The American side argued that interbank markets (particularly the interbank brokerage or _tanshi_ market), specialized banking markets, such as trust and pension fund management, and Japanese equity markets (with particular regard to underwriting) should be opened fully to foreign firms. After pointing out that the pension and trust advisory market was opened to foreign firms April 1, the Japanese team presented a plan to restructure the interbank brokerage mart to give both foreign and domestic banks greater competitive opportunities.

- Japanese access to foreign financial products - The Americans noted that regulations prevent Japanese savers from taking advantage of instruments offered in offshore markets and prevent foreign firms from offering in Japan innovative foreign-based products, hobbling foreign financial competitors. As specific examples of restrictions on foreign competition Mr. Mulford pointed to the prohibitions on offshore investment accounts, barriers to Merrill Lynch Japan Inc.'s efforts to sell U.S.-based asset-backed money market funds to Japanese investors and MOF's cautious approach to Globex, the Chicago Mercantile Exchange's 24-hour, electronic commodity-futures trading system. MOF countered that tentative approval for domestic use of Globex was given recently and that approval for Merrill Lynch Japan's synthetic security is also likely. The ministry defended some of its caution, however, saying that it cannot shirk its responsibility to assure the soundness of domestic financial markets and to protect the interests of Japanese investors.

- Tax and administrative matters - The American team argued that Tokyo should take a hard look at distorting taxes and problems of administrative transparency in order to bring Japan's financial markets more into line with American and European norms. Mr. Mulford pointed to the withholding tax on Japanese treasury bills, the lack of foreign input into the numerous government financial advisory councils and the lack of transparency in general as significant barriers to greater foreign participation in Japan's financial markets. Mr. Utsumi countered that current Japanese fiscal policy leaves little room for tax reductions and that his ministry is open to foreign complaints.

The American delegation's suggestions did not contain any new points of significance but were far broader in scope than before. Demands for a clear, accelerated implementation schedule reinforced the impression that the executive branch wants to be seen as pushing hard on Tokyo. With several financial reciprocity bills already introduced on Capitol Hill and congressional ire still unappeased, the administration wants the government of Toshiki Kaifu to act before things get out of hand. Under a provision of the 1988 Omnibus Trade and Competitiveness Act, the White House must report by the end of this year whether Japan and other countries give U.S. financial institutions the same access to their markets that foreign firms receive in the United States. Mr. Mulford underscored his concern in a warning: "As of today, it will not be possible for the U.S. Treasury to give a positive report on the Japanese market." While the Finance Ministry can point rightly to a long list of actions designed to open Japan's financial markets and to help foreign firms compete in these markets, the financial liberalization issues that remain are more complex and have a greater potential for disruption than ever before.

Jon Choy

New Land Taxes May Be Proposed By Autumn

Japan's high land prices, included in the April interim report on the Structural Impediments Initiative talks as a barrier to foreigners wanting to enter the Japanese market, will be at the vortex of tax discussions this year. Since the government's Tax Commission began hearings May 13 on current land taxation policies, scholars and businessmen have joined officials from the Ministries of Construction, International Trade and Industry, Agriculture, Forestry and Fisheries and the National Land Agency in proposing various tax changes to restrain skyrocketing land prices. The wide-ranging discussions cover the low effective rate of land taxes as well as ways to strengthen the special tax on idle land, reevaluate corporate-held land and improve taxation of agricultural land in metropolitan areas. The Construction Ministry and the National Land Agency back steeper taxes on all land, but MITI and MAFF say that any increase in the tax burden must take into account the impact on businesses and farmers. Few expect the Tax Commission to come to any conclusions by the time the final SII report is released in July; the soonest that specific recommendations might be ready is October.

The ruling Liberal Democratic Party also is looking at land problems through its Tax Committee, which held the first meeting on this subject May 10. The Tax Committee, which is regarded as historically having much more power to achieve changes in tax laws than the government's Tax Commission, is scheduled to hold weekly meetings from May 24 in an effort to decide fundamental land taxation policies by late July or early August. Committee members would like to have the details worked out by October so they can submit proposed changes to the Diet by the end of FY 1990.

In an April 13 interview with Nihon Keizai Shimbun, new Tax Committee chairman Masajuro Shiokawa, a former transportation minister, outlined two main goals: effective utilization of idle land and a review of the rigid land-use structures imposed by the Land Lease Law and the House Lease Law, both of which virtually prohibit an owner from evicting a tenant after the expiration of a lease. Mr. Shiokawa noted that even if land taxation policies are overhauled, the supply of land and housing will not increase much without changes in the use of idle land and the legal regime. Therefore, LDP officials plan to hammer out a new land policy prior to deciding on any tax changes.

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JAPANESE BANKS IN THE UNITED STATES

Summary

Japanese banks, the world's largest if measured by assets, have established an international presence. They steadily expanded their activities in the United States during the 1980s and by the same measure are easily the largest foreign presence in this country's banking market. The asset yardstick exaggerates both their global preeminence and their U.S. position, but few experts would deny the important role of Japanese banks in this country's financial structure.

Competition across an ever broader range of financial services, such as offering credit guarantees or helping finance leveraged buyouts, has created cost savings for U.S. firms and state and local governments, especially local authorities that have solicited business from Japanese banks. These new activities -- plus expanded loan and deposit-taking businesses -- have widened the influence of Japanese banks in U.S. financial markets.

Even though few individual Americans have personal experience with Japanese banks, U.S. politicians are paying close attention to their growth. This intense scrutiny suggests the possibility of new restrictions. For this and other reasons Japanese bank activity may grow relatively slowly in the United States during the early 1990s.

Japanese Banks in the World Economy

Japanese banks' rapid rise to the top ranks among all the world's banks is well documented, as is the relative decline of U.S. banks. An American

Japan Economic Institute 1000 Connecticut Avenue, N.W., Washington, D.C. 20036 202-296-5633

Banker survey that listed banks worldwide on the basis of assets as of December 31, 1988 showed Japanese institutions monopolizing the top 10 spots; Dai-Ichi Kangyo Bank, Ltd. topped the lot with $386.9 billion in assets. Twenty years ago American banks held most of the top 10 spots, according to comparable studies. In the American Banker study the largest U.S. bank, Citibank NA, ranked 24th, with 17 Japanese banks ahead of it. DKB on this basis was more than twice the size of Citibank.

Other comparisons are slightly more favorable to U.S. banks. When bank companies, rather than the individual banks themselves, are ranked by assets, Citicorp, which includes many entities other than Citibank, rises to 12th place. DKB retains its number-one ranking at nearly twice Citicorp's size. Even on this basis, however, Citicorp is the lone American institution among the world's 25 largest banking companies, which includes 17 concerns from Japan.[1]

Yet Citicorp and other American banks continue to enjoy the respect of their Japanese rivals. Other considerations explain why this is so. U.S. banks have a much higher proportion of their banking business in activities that do not generate assets on balance sheets. For example, Citicorp is active in arranging leveraged buyouts but ends up holding few of the resultant loans or bonds generated by such activity. Its role as organizer, however, results in fees large enough at times to dwarf the amount of interest earned by the institutions that actually provide the LBO funding. For this reason many experts believe that rankings based on assets alone are seriously flawed; they have proposed other measurements.

The Banker, a British publication, for example, changed its yardstick in its most recent survey. It ranked the world's banks according to the size of their primary capital, a concept roughly equal to funds paid into the bank by stockholders and accumulated over the years by the bank through retained earnings. (This measure corresponds closely to so-called Tier 1 capital as defined by the Bank for International Settlements for purposes of measuring capital adequacy. Capital adequacy ratios are discussed below.) This measure changes relative sizes dramatically. Two British banks, National Westminster Bank PLC and Barclays Bank PLC, claim the top two spots. Citicorp edges out Fuji Bank, Ltd. for third place, with $9.9 billion in capital compared to the Japanese institution's $9 billion. Japanese banks claim six of the top 10 places (DKB ranks seventh) and 10 of the top 20. Among American banks other than Citicorp, only J.P. Morgan Corp., which ranks 19th on this basis, cracks the top 20.

The Banker also provides employment data. On this basis the two British banks again finish just ahead of Citicorp, which has 89,000 employees, 4.8 times as many as DKB, Japan's largest. In fact, at least eight American banks have more employees worldwide than the biggest Japanese institution.[2]

[1] American Banker, July 25, 1989, pp. 23 and 32.

[2] The Banker, July 1989, p. 54.

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All the measures presented so far combine the domestic and the international activities of the banks in question. For the purpose of considering Japanese banking activity in the United States, international assets are the relevant statistic. According to the Bank for International Settlements, Japanese-owned banks had foreign assets of $1.8 trillion at the end of 1988, more than double the figure for banks headquartered in the United States, the runner-up. An estimated quarter of these assets and Japanese bank branches are located in the United States, based on Bank of Japan and Federal Reserve Board data.

Factors in Japanese Bank Investment in the United States

Being large does not necessarily imply a foreign presence. Some of the biggest U.S. banks have little activity overseas. To justify a move abroad a bank, like any other firm, has to meet two criteria. First, the good or service cannot be provided at comparable cost from its home base. Second, it must have some advantage not available to rivals based in the host country.[3]

Banking services, unlike manufactured products, fairly easily fulfill the first criterion. Banks prefer to be physically close to markets of interest to clients, whether existing or potential. This traditionally has implied a widely dispersed network of offices. With new communications technologies, however, an increasing number of activities can be conducted over long distances. That has led many banks to consolidate their worldwide operations in fewer locations, although the steady rise in Japanese branch offices abroad from 127 to 272 during the 1980s ran counter to this trend.

The second criterion -- that the disadvantages of a foreign-based bank extension be offset by some advantage over local rivals -- is far less obvious. Clearly, foreign entrants face some formidable obstacles. Banking regulations, for example, differ dramatically from country to country, putting a foreign competitor at a disadvantage even if local laws do not discriminate against outsiders. In addition, the technological infrastructure differs around the world; automated teller machine networks as sophisticated as those in the United States and Japan would be unthinkable in many countries. A bank accustomed to providing services in this way has to come up with alternatives in markets where ATMs do not exist. Moreover, language and customs loom large in an activity as people-oriented as retail banking. In fact, a few of today's large U.S. banks got their start as small banks catering to immigrant communities that felt uncomfortable with existing U.S. institutions. While language and cultural differences may create niches for overseas banks in the U.S. market, the same factors tend to confine foreign banks to those niches.

If banks have a real, albeit diminishing, need for foreign branches and face real disadvantages in establishing such a presence, then the increased

[3] This discussion follows closely an argument associated with Richard Caves of Harvard University, although Mr. Caves primarily discusses manufacturing. See Richard E. Caves, "International Trade, International Investment, and Imperfect Markets," Special Papers in International Economics, No. 10, 1974, pp. 17-26. For an application of Cave's model to Japanese banks in the United States, see Henry Terrell, "U.S. Banks in Japan and Japanese Banks in the United States: An Empirical Comparison," Quarterly Review of the Federal Reserve Bank of San Francisco, Summer 1979.

level of foreign -- especially Japanese -- banking activity in this country has to be based on significant, and growing, incentives. While some analysts see a cost-of-funds advantage for Japanese banks operating in the United States, others identify a strong pull from linkages with trade and investment activities.

Cost of Funds - Many American analysts believe Japanese banks can raise funds very inexpensively at home, where interest rates on deposits are more controlled than in this country. Japanese banks then can transfer these funds to their U.S. offices where they become weapons in capturing market share from American banks. This argument also suggests that when Japanese banks lend funds at what look like ridiculously low margins they are acting as if they were protected from failure by their government.

An American seeking a home mortgage, especially in California where Japanese banks are most active in the consumer market, might be tempted to applaud this apparent foreign aid, which benefits his or her personal aspirations for a home. However, the argument has limited validity. A large part of Japanese bank lending is funded from sources in the United States. Unpublished Federal Reserve Board data for December 31, 1988 indicated that 63 percent of the liabilities (funding sources) for U.S. agencies and branches of Japanese banks was from U.S. sources. The remaining 37 percent came from sources in Japan and elsewhere.

In fact, U.S. branches of Japanese banks even lend to the home office. Henry Terrell, Robert Dohner and Barbara Lowrey have found that deposits grew more slowly than loans in Japan between 1980 and 1988, with considerable year-to-year fluctuation in each. During periods when loans exceeded deposits by more than average amounts, the U.S. assets of Japanese banks increased by a commensurate volume.[4] The same result held for the activities of Japanese banks in the United Kingdom. In a sense the U.S. affiliates of Japanese banks serve an important role as suppliers of funds to the Japanese market, the reverse of what the U.S. bankers' argument implies, although it is consistent with the chronic inflow of short-term capital into Japan reported in the country's balance of payments statistics. (For details of Japan's 1989 current account statistics, where this inflow came to $20.8 billion, see JEI Report No. 7B, February 16, 1990.)

Of course, funds move the other direction as well. To the extent that the flow from Japan finances U.S. activities and involves an exchange of currency, the lender faces the danger that the dollar will decline vis-a-vis the yen. Should this happen, the hypothetical American borrowing through a U.S. affiliate of a Japanese bank indirectly could return to the home office of the Japanese bank fewer yen than he or she borrowed. In other words, the yen-denominated return could well be negative in the face of the yen's appreciation. To avoid this possibility a Japanese lender to U.S. clients could purchase yen in the forward market. Only if the cost of such cover is less than the difference in interest rates between the United States and Japan will a U.S. investment clearly be in the Japanese investor's interest. However, during the 1980s such

[4] Henry S. Terrell, Robert S. Dohner and Barbara R. Lowrey, "The U.S. and U.K. Activities of Japanese Banks: 1980-1988," Board of Governors of the Federal Reserve System International Finance Discussion Paper No. 361, 1989, pp. 26-28.

covered differentials on market interest rates largely vanished. (For details, see JEI Report No. 16A, April 20, 1990 and the references cited therein.)

The interest rate differential argument still carries weight, however. For example, the Japanese bank could have periods when it has a surplus of particularly low-cost funds that carry less than market interest rates. In addition, Japanese banks could respond to interest rate differentials by increasing their lending in the United States, bearing the risk of the currency fluctuation as one of the costs of doing business. The Terrell, Dohner and Lowrey study found that Japanese banks do increase their lending activity in the United States during periods when the nominal market interest rate gap widens between the United States and Japan.[5] This suggests that the flow of bank funds to the United States may carry considerable currency risk.

Levels of Trade and Investment - Japan's expanding trade and investment have reached particularly high levels in California. Japanese banks also have stepped up their activity in this country, especially in that state. Many analysts have noticed the connection and concluded that trade flows have caused the increase in Japanese bank activity.[6]

Like their American counterparts, Japanese exporters are more used to dealing with banks from their homeland. As a result, when they require foreign exchange, letters of credit and other trade-related financial services for their increased exports and imports, they typically have turned to Japanese banks. These considerations suggest that foreign banks follow trade. However, American and Japanese firms looking for export opportunities in Eastern Europe are discovering that an increase in trade can be smoother if a familiar banking system already is in place, suggesting that banks can lead trade.

Trade, in turn, often leads to investment. Exports from Japan create a stake in the American market for Japanese companies. Once that stake becomes large enough, direct foreign investment is feasible; if trade restrictions loom, it becomes something of an imperative. As investment spreads, so does the incentive for banks to follow. For example, few regard as accidental the presence of Mitsui Taiyo Kobe Bank, Ltd., Sanwa Bank, Ltd. and Tokai Bank, Ltd. in Lexington, Kentucky, not normally considered a center of foreign banking activity. In nearby Georgetown sits a car assembly plant owned by Toyota Motor Corp., in which the three banks are the largest stockholders. In addition, Tokai Bank's home office is in Nagoya, not far from Toyota's world headquarters. Mitsui Taiyo Kobe Bank is the lead bank participant in the Mitsui *keiretsu* and is a member of that group's presidents' club, as is Toyota. (For more on *keiretsu* and presidents' clubs, see JEI Report No. 2A, January 12, 1990.) Although Mitsui Taiyo Kobe Bank's office in Lexington cannot conduct banking business, it does serve a valuable function in helping Toyota deal with the intricacies of American banking.

While the above example suggests that banking follows investment, sometimes the reverse is true. Dai-Ichi Kangyo Bank of California noted in its 1989 annual report that it played a key role in attracting Kobe Precision, Inc. to Hayward, California in 1988 after introducing its parent, Kobe Steel, Ltd., to various California communities during its search for a U.S. production site. Negotiations between DKB-California and the Industrial Development Authority of Alameda County resulted in the issuance of low-cost industrial revenue bonds backed by a guarantee from DKB, the parent of DKB-California.

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[5] *Ibid.*

[6] *Ibid.* See also Gary C. Zimmerman, "The Growing Presence of Japanese Banks in California," *Federal Reserve Bank of California Economic Review*, Summer 1989, pp. 4-7.

The preceding examples are not meant to suggest that the trade-investment-banking pattern is one that only Japanese firms follow. American banks played a similiar role in the postwar expansion of U.S. multinationals. In addition, U.S.-owned banks have a good track record for courting Japanese investment. In some such cases the American bank had long-standing U.S.-Japan expertise stemming from trade ties developed earlier.

The conclusion to be drawn from these examples is that trade, direct investment and Japanese banks in the United States are closely linked, but the causation runs in every direction. Areas of the country that have high levels of trade with Japan, such as the Pacific Northwest (which is primarily an exporter to Japan), also have comparatively high levels of Japanese investment and Japanese banking operations. This conclusion suggests that regions that have been left largely outside direct U.S.-Japan trade, perhaps because of their inland location, have a special reason to encourage Japanese-owned banks to locate in their area if they are interested in attracting Japanese direct investment.

Size and Distribution of Japanese Banks in the United States

In short, Japanese banks have several important advantages that permit them to be profitable in the United States and to overcome the disadvantages typically associated with operations in this country. The positive factors generally have grown, with the result that Japanese-owned institutions steadily became more important in the United States during the 1980s. As of May 1990 total employment in this country's Japanese-owned banks came to at least 25,000, with Americans accounting for an overwhelming percentage of the total, according to JEI estimates.

Much of the growth of Japanese banks has come at the expense of banks headquartered in foreign countries other than Japan. As Tables 1 and 2 show, the expansion in foreign banking activity in the United States during the last half of the 1980s was almost entirely a result of the growth of Japanese banks. A comparison of the two tables shows that the shares of both non-Japanese and Japanese banks consistently have been higher for commercial and industrial lending than for total assets, which roughly corresponds to total lending.

By the end of 1989 Japanese banks in the United States were both the biggest and the fastest growing among the 10 foreign banks with the largest representation. The U.S. presence of Japan-based institutions grew 19 percent per year between 1980 and 1989 measured by assets; runner-up Italy experienced 16.9 percent annual growth over the same period. (In 1980 British banks had been second largest but by 1989 were in fourth place.) Japan's share of foreign bank assets in the United States went from 36.6 percent to 57 percent during this period.

These figures must be interpreted with caution. As noted earlier, judging relative size from asset levels can be misleading. Arguably, Japanese banks

Table 1: Share of Foreign Bank Assets in Total U.S. Bank Assets, 1985-89

(June 30 of each year)

	Japanese Banks	Other Foreign Banks	Total Foreign Banks
1985	7.0%	11.6%	18.6%
1986	7.9	10.5	18.4
1987	10.1	10.8	20.9
1988	11.2	10.6	21.8
1989	12.1	10.5	22.6

Source: Calculated from data in American Banker, various issues.

Table 2: Foreign Share of Total U.S. Commercial and Industrial Lending, 1986-89

(June 30 of each year)

	Japanese Banks	Other Foreign Banks	Total Foreign Banks
1986	8.9%	13.2%	22.1%
1987	11.0	13.8	24.8
1988	13.9	13.6	27.5
1989	16.0	12.5	28.5

Source: Calculated from data in American Banker, various issues.

in the United States engage in more asset-based activity than do either their American or foreign bank rivals, inflating their apparent size. In addition, banks have the option of booking some of their U.S. activity in foreign offices, thereby avoiding certain domestic regulations; if the banks of one country are more prone to do this than their counterparts in other nations, their relative size in the United States will be understated. Some European banks report to their stockholders and others much higher levels of U.S. assets than those filed with the Federal Reserve Board (the basis of the data in the tables). For example, Barclays Bank claimed 1988 U.S. assets of $25 billion but told the Fed it had only $7.8 billion. Skandinaviska Enskilda Banken, Sweden's largest bank, reported $336 million in U.S. assets to the Fed but $727 million to its stockholders, an amount that included assets booked at its Cayman Islands branch. According to some experts, the Ministry of Finance rides herd on Japanese banks harder than do European authorities, minimizing these discrepancies. If so, the position of Japanese banks in the United States relative to those of Europe may be overstated substantially.[7]

[7] This argument follows closely one made by James Alexander, "Muscle or Mirage?" The Banker, March 1990, pp. 33-34.

No data are available to solve this puzzle completely. However, using additional Fed figures on lending to nonfinancial firms from banks and nonbanks located outside the United States, Herbert L. Bauer of the Federal Reserve Bank of Chicago estimated the share of commercial and industrial lending accounted for by foreign firms to be 28.3 percent in 1988, higher than the 20.7 percent figure he calculated for just U.S.-situated foreign banks. No breakout by country is available, but even if none of the increment was added by Japanese banks, they still would be left with the largest share of such foreign bank lending in the United States.[8]

In short, Mr. Bauer's results are consistent with ascribing a large role to Japanese banks in the United States. Like other foreign banks, they may play that role using one of several organizational forms. Branches and agencies, while restricted in the kinds of business they can conduct, are comparatively unregulated by U.S. authorities; conversely, Japanese regulatory agencies wield considerable authority over these types of operations. Branches and agencies rarely offer services to individuals -- in part because such business would require them to have insurance with the Federal Deposit Insurance Corp. But they are important in international transactions. Subsidiaries play a reverse role. They often offer services to individual Americans. Moreover, they are considered U.S. banks for many purposes and are required to have FDIC insurance; in addition, subsidiaries are firmly under the thumb of federal, and sometimes state, regulatory authorities. Generally, data are far more complete about subsidiaries since they have greater U.S. reporting requirements.

Subsidiaries, agencies and branches differ dramatically in importance by state. In California, for example, subsidiaries are important (see Table 3).

Table 3: Distribution of Assets of Japanese Banks by State, December 31, 1989

(in millions of dollars)

	Agencies	Branches	Subsidiaries	Other	Total
New York	$448	$258,883	$23,368	$158	$282,857
California	50,421	12,505	36,097	22	99,045
Illinois	0	30,584	0	0	30,584
Oregon	0	2,424	0	0	2,424
Texas	1,906	0	0	7	1,913
Georgia	1,550	0	0	0	1,550
Washington	0	1,471	0	0	1,471
Massachusetts	0	369	0	0	369
Florida	298	0	0	66	364
Hawaii	167	0	0	0	167
Total	54,791	306,237	59,465	252	420,746

Source: Federal Reserve Board, unpublished data.

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[8] Herbert L. Bauer, "Foreign Competition in U.S. Banking Markets," Economic Perspectives, May/June 1990, p. 23.

After Congress passed the 1978 International Banking Act Japanese and other foreign banks were required to choose a "home away from home" -- a single U.S. state where they could operate a subsidiary. A handful of banks, including Bank of Tokyo, Ltd., were granted exceptions because they already operated subsidiaries in more than one state. Not surprisingly, many Japanese banks opted for California; the remainder chose New York. This suggests that Japanese banks currently would face a substantial legal barrier in expanding their retail banking services beyond New York and California. (One Japanese-owned bank, Bank of California (a unit of Bancal Tri-State Corp.), operates a few offices in Washington and Oregon under a separate grandfather clause granted the bank before it was sold to Mitsubishi Bank, Ltd. in 1984.)

The data also show that a handful of locations dominate activity. Outside California Japanese banks are found only in medium to large cities, but even relatively large cities, such as Indianapolis, Indiana and Milwaukee, Wisconsin, have no Japanese banks at all. In sparsely populated areas Japanese banks are completely absent. Across the northern tier of states, for example, there is no Japanese-owned bank presence between Minneapolis, Minnesota and Bellevue, Washington, just outside Seattle.

Comparisons with 1980 Federal Reserve Board figures show that some states have attracted much more interest in recent years. For example, Texas virtually prohibited Japanese banks until 1985, when it permitted agencies. As a result rapid growth has occurred in recent years. Georgia, Massachusetts and Florida had no Japanese banking activity at all in 1980. Illinois' position as the third most active location is a relatively recent development; in 1980 Washington and Oregon collectively were more important.

The absence of Japanese banks from much of the country does not mean they are totally unrepresented there. Japanese and other banks also operate representative offices, which have no legal authority to conduct banking business. (The offices of Mitsui Taiyo Kobe Bank, Sanwa Bank and Tokai Bank in Lexington, Kentucky are representative offices.) Such offices do, however, make referrals to other banks and serve as listening posts in sensitive locations, such as Washington, D.C. Table 4 provides a state-by-state breakdown of agencies, branches and representative offices operated by Japanese banks.

Japanese banks also own nonbank entities that may operate nationwide. For example, Fuji Bank's Heller International Corp. makes asset-based loans across the country. Some of these nonbank activities are described below.

Some U.S. subsidiaries of Japanese banks maintain offices abroad. For example, both Union Bank, a Bank of Tokyo subsidiary, and Bancal Tri-State (Bank of California) operate representative offices in Tokyo. In late May Fuji Bank and Mitsubishi Bank were reported in the Japanese press as planning to use Heller and Bank of California, respectively, as a means of expanding their presence in Southeast Asia, thereby largely circumventing the difficult Ministry of Finance regulatory process concerning such activity.

As measured by U.S. assets, Japanese banks have reached a size where they rival U.S. banks in this market. Table 5 shows that the Bank of Tokyo, including its subsidiaries in California and New York, was the largest Japanese bank in the United States as of December 31, 1989. Were BOT's $47 billion of U.S. assets held by a separate U.S. bank holding company, it would rank easily

Table 4: Japanese Bank Offices by State and City, June 30, 1989

	Agencies	Branches	Subsidiaries	Other	Representative Offices	Total
California						
Los Angeles	19	5	4	0	1	29
San Francisco	4	1	4	2	4	15
Total	23	6	8	2	5	44
District of Columbia	0	0	0	0	2	2
Florida						
Coral Gables	1	0	0	0	0	1
Miami	0	0	0	1	1	2
Total	1	0	0	1	1	3
Georgia (Atlanta)	4	0	0	0	9	13
Hawaii (Honolulu)	1	0	0	0	0	1
Illinois (Chicago)	0	14	0	0	8	22
Kentucky (Lexington)	0	0	0	0	3	3
Massachusetts (Boston)	0	1	0	0	0	1
Michigan (Southfield)	0	0	0	0	1	1
New York (New York)	1	38	17	2	20	78
Ohio						
Cleveland	0	0	0	0	1	1
Columbus	0	0	0	0	1	1
Total	0	0	0	0	2	2
Oregon (Portland)	0	1	0	0	1	2
Texas						
Dallas	1	0	0	0	2	3
Houston	3	0	0	1	12	16
Total	4	0	0	1	14	19
Washington (Seattle)	0	3	0	0	4	7
Total	34	63	25	6	70	198

Notes: Excludes offices of Bank of Japan, Japan Development Bank and Export-Import Bank of Japan.

Each subsidiary may have two or more retail branches. A handful of such subsidiary banks have branch networks of several dozen retail branches each and at least two networks have over 100 retail branches.

In September 1989 Daiwa Bank, Ltd. and Lloyds Bank PLC reached agreement for Daiwa to acquire 15 branches, agencies and representative offices of Lloyds. Legal closing occurred March 1, 1990. The above list does not reflect this transaction. The facilities are in Boston, Hartford, New York City, Philadelphia, Baltimore, Atlanta, Tampa, Miami, Pittsburgh, Chicago, St. Louis, Minneapolis, Dallas, Los Angeles and San Francisco.

Source: American Banker, annual reports and telephone inquiries of Japanese-owned banks and subsidiaries

among the 20 largest U.S. bank companies, about the size of First Chicago Corp. and Wells Fargo & Co.

Table 5 reflects several changes in recent years. Bank of Tokyo added about $8.3 billion in 1988 yearend assets with its acquisition of Union Bank and regained the top U.S. spot from Mitsubishi Bank, which had been larger in JEI's previous survey of Japanese banks in the United States based on June 30, 1987 data (see JEI Report No. 3A, January 22, 1988). (BOT merged its existing

Table 5: Japanese Bank Groups in the United States Ranked by Assets, December 31, 1989

(in thousands of dollars)

	Agencies	Branches	Subsidiaries	Other	Total
Bank of Tokyo, Ltd.	$3,076,752	$22,320,747	$21,758,155	$6,531	$47,162,185
Mitsubishi Bank, Ltd.	507,757	31,567,873	7,234,207	154,054	39,463,891
Dai-Ichi Kangyo Bank, Ltd.	5,308,959	31,456,001	530,986	--	37,295,946
Fuji Bank, Ltd.	5,395,240	26,084,280	3,679,027	10,223	35,168,770
Sanwa Bank, Ltd.	1,381,694	24,296,035	6,128,673	--	31,806,402
Industrial Bank of Japan, Ltd.	6,308,816	14,158,460	8,221,896	81,569	28,770,741
Sumitomo Bank, Ltd.	1,262,769	21,056,046	4,400,655	--	26,719,470
Tokai Bank, Ltd.	5,035,817	12,630,701	1,127,179	--	18,793,697
Mitsui Bank, Ltd.	2,020,920	15,344,688	1,346,558	--	18,712,166
Mitsui Trust & Banking Co., Ltd.	3,795,171	9,825,696	252,922	--	13,873,789
Mitsubishi Trust & Banking Corp.	2,841,196	10,058,911	441,371	--	13,341,478
Long-Term Credit Bank of Japan, Ltd.	2,879,633	9,045,905	992,370	--	12,917,908
Daiwa Bank, Ltd.	1,844,851	8,066,773	2,318,116	--	12,229,740
Sumitomo Trust & Banking Co., Ltd.	1,851,184	8,934,199	586,778	--	11,372,161
Yasuda Trust & Banking Co., Ltd.	3,605,937	5,856,971	228,251	--	9,691,159
Taiyo Kobe Bank, Ltd.	1,193,343	8,419,946	51,516	--	9,664,805
Nippon Credit Bank, Ltd.	1,999,230	5,357,808	--	--	7,357,038
Kyowa Bank, Ltd.	1,355,214	3,776,524	108,231	--	5,239,969
Toyo Trust & Banking Co., Ltd.	1,263,827	3,750,797	58,245	--	5,072,869
Saitama Bank, Ltd.	--	4,948,320	--	--	4,948,320
Hokkaido Takushoku Bank, Ltd.	697,470	3,407,361	--	--	4,104,831
Norinchukin Bank, Ltd.	--	3,944,157	--	--	3,944,157
Chiba Bank, Ltd.	--	3,301,854	--	--	3,301,854
Joyo Bank, Ltd.	--	2,735,378	--	--	2,735,378
Chuo Trust & Banking Co., Ltd.	474,734	2,218,703	--	--	2,693,437
Bank of Yokohama, Ltd.	241,890	1,900,471	--	--	2,142,361
Shizuoka Bank, Ltd.	448,372	1,157,693	--	--	1,606,065
Hokuriku Bank, Ltd.	--	1,481,142	--	--	1,481,142
Hiroshima Bank, Ltd.	--	1,436,656	--	--	1,436,656
Shoko Chukin Bank, Ltd.	--	1,349,139	--	--	1,349,139
Zenshinren Bank, Ltd.	--	1,225,880	--	--	1,225,880
Hyakujushi Bank, Ltd.	--	1,077,485	--	--	1,077,485
Hachijuni Bank, Ltd.	--	886,485	--	--	886,485
Bank of Fukuoka, Ltd.	--	671,827	--	--	671,827
Bank of Kyoto, Ltd.	--	600,979	--	--	600,979
Hokkaido Bank, Ltd.	--	551,986	--	--	551,986
Gunma Bank, Ltd.	--	539,489	--	--	539,489
Ashikaga Bank, Ltd.	--	418,286	--	--	418,286
Suruga Bank, Ltd.	--	223,110	--	--	223,110
Iyo Bank, Ltd.	--	137,416	--	--	137,416
Tokyo Tomin Bank, Ltd.	--	15,100	--	--	15,100
Total	54,790,776	306,237,278	59,465,136	252,377	420,745,567

Source: Federal Reserve Board, unpublished data.

California First subsidiary with Union Bank and adopted the name of the acquired institution for the new entity.)

The list also grew. For example, Tokyo Tomin Bank, Ltd. upgraded its New York representative office to branch status late in 1989. Like Tokyo Tomin, most of the institutions at the bottom of the list are regional banks that have opened a branch in New York in recent years.

Table 6 shows the bank subsidiaries of Japanese banks. As noted earlier, all are either in New York or California. The New York subsidiaries often specialize in trust business, while the California banks are more likely to offer a broad range of retail banking services, including checking accounts and credit cards. The subsidiaries of Japanese banks occupy four of the top 10 positions among California banks, as measured by assets, although they are

Table 6: Subsidiaries of Japanese Banks in the United States Ranked by Assets, December 31, 1989

(in thousands of dollars)

Subsidiary	Parent	State	Assets
Union Bank	Bank of Tokyo, Ltd.	California	$15,220,764
Bank of California	Mitsubishi Bank, Ltd.	California	7,234,207
Bank of Tokyo Trust Co.	Bank of Tokyo, Ltd.	New York	6,537,391
Sanwa Bank California	Sanwa Bank, Ltd.	California	6,128,673
Industrial Bank of Japan Trust Co.	Industrial Bank of Japan, Ltd.	New York	5,575,034
Sumitomo Bank of California	Sumitomo Bank, Ltd.	California	4,400,655
Fuji Bank & Trust Co.	Fuji Bank, Ltd.	New York	3,679,027
IBJ Schroder Bank & Trust Co.	Industrial Bank of Japan, Ltd.	New York	2,646,862
Daiwa Bank Trust Co.	Daiwa Bank, Ltd.	New York	2,318,116
Mitsui Manufacturers Bank	Mitsui Bank, Ltd.	California	1,346,558
Tokai Bank of California	Tokai Bank, Ltd.	California	1,127,179
LTCB Trust Co.	Long-Term Credit Bank of Japan, Ltd.	New York	992,370
Sumitomo Trust and Banking Co. USA	Sumitomo Trust & Banking Co, Ltd.	New York	586,778
Dai-Ichi Kangyo Bank of California	Dai-Ichi Kangyo Bank, Ltd.	California	530,986
Mitsubishi Trust & Banking Corp. (U.S.A.)	Mitsubishi Trust & Banking Corp.	New York	441,371
Mitsui Trust Bank U.S.A.	Mitsui Trust & Banking Co., Ltd	New York	252,922
Yasuda Bank and Trust Co. USA	Yasuda Trust & Banking Co, Ltd.	New York	228,251
Kyowa Bank of California	Kyowa Bank, Ltd.	California	108,231
Toyo Trust Company New York	Toyo Trust & Banking Co., Ltd.	New York	58,245
Taiyo Kobe Bank & Trust Co.	Taiyo Kobe Bank, Ltd.	New York	51,516
Dai-Ichi Kangyo Trust Co. of New York	Dai-Ichi Kangyo Bank, Ltd.	New York	n.a.
Mitsubishi Bank and Trust Co.	Mitsubishi Bank, Ltd.	New York	n.a.
Mitsui Finance Trust Co.	Mitsui Bank, Ltd.	New York	n.a.
Sumitomo Bank New York Trust Co.	Sumitomo Bank, Ltd.	New York	n.a.
Tokai Trust Co.	Tokai Bank, Ltd.	New York	n.a.
Total			59,465,136

Source: Federal Reserve Board, unpublished data.

dwarfed by the four largest banks in the state -- Bank of America NT&SA, Security Pacific National Bank, Wells Fargo Bank NA and First Interstate Bank of California. Nor do the Japanese subsidiaries have extensive retail operations in other Pacific states as do rivals Bank of America, Security Pacific and

First Interstate. They do have access, however, to the worldwide resources of their parents, including the branches and agencies of the parents in California.

In sum, Japanese banks unquestionably are a major force in the American banking market, although the official data may overstate their dominance over other foreign banks. Their mere size alone, however, suggests relatively little about what they do. It is that subject that the next section addresses.

What Japanese Banks Do in the United States

Japanese banks are particularly active in international trade finance in America. This activity can take the form of financing imports from Japan or, increasingly, exports to Japan. Other lending is in connection with direct investment that involves a Japanese firm, often with an American partner. For example, Mitsubishi Bank along with Morgan Guaranty Bank, took the lead in 1988 in arranging complex financing -- ultimately about $500 million worth -- for the Mitsubishi Motors Corp.-Chrysler Corp. joint venture in Illinois that produces cars for both companies. Similarly, in 1988 Sanwa Bank lent $55 million to Wheeling-Nisshin Inc., a joint venture of Nisshin Steel Co., Ltd. and Wheeling-Pittsburgh Steel Corp. that operates a steel coating plant in Follansbee, West Virginia.

On the face of it, such traditional banking usually is an easy business: the bank merely takes an individual's or a firm's money and lends it to someone else, covering expenses and making a profit on the difference between the relatively high lending rate and the lower rate paid on savings. However, in recent years in Japan and elsewhere new rivals have cropped up, perhaps because the business is so straightforward. In addition, large corporations increasingly raise their own funds. As a result, banks have had to narrow their margins to compete for the remaining business, and the activity has lost some of its appeal. Another response has been for banks to seek new opportunities from the fairly short menu of choices offered them by regulatory authorities.

These choices have been particularly constricted in Japan. Even though Washington has been less accommodating than several European governments, the size of the U.S. market and its extensive trading and investment relations with Japan have made this country attractive for Japanese banks, which try out innovations, some of which would be difficult or impossible to implement at home.

The most obvious option is to move into new kinds of lending. Both American and Japanese banks increasingly have emphasized lending to medium-sized firms in the United States. (Definitions vary, but one widely used criterion describes these firms as having between $10 and $250 million in revenues per year.) Many Japanese acquisitions in the 1980s clearly had the objective of moving Japanese banks into the middle market. In 1981 Mitsui Bank, Ltd., a predecessor to Mitsui Taiyo Kobe Bank, purchased Manufacturers Bank, a California lender to such firms. In 1984 Fuji Bank bought Heller International, which has a similar middle-market focus. Analysts interpreted Bank of Tokyo's 1988 purchase of Union Bank from Standard Chartered PLC as an effort to strengthen the relatively weak position in that niche of BOT's existing California subsidiary, California First.

This area of interest continues. In September 1989 two Japanese banks announced initiatives that analysts interpreted as indicative of interest in the middle market. Dai-Ichi Kangyo Bank purchased 60 percent of CIT Group, a finance company that specializes in lending and leasing to medium-sized firms, from Manufacturers Hanover Corp. (As part of the deal DKB also acquired a small share of Manny Hanny itself.) In addition, Daiwa Bank, Ltd. purchased 15 American branches and representative offices owned by Lloyds Bank PLC, the British giant, in a move that was thought to position Daiwa for lending to the same segment of the overall market.

While Japanese banks have shown more interest in relatively small American businesses than they had previously, they also increasingly have been involved in deals that restructure U.S. corporate giants. For example, Japanese bankers were engaged on both sides of the 1988 takeover battle for Federated Stores Inc. between R.H. Macy & Co. and eventual winner Campeau Corp. Although Japanese banks sold much of their commitment to others, including a number of relatively small Japanese financial institutions, when Campeau declared bankruptcy in January most of those that had been involved faced substantial losses. Some estimates put the Japanese bank share of overall American LBO lending as high as 25 percent, which compares with a U.S. bank share of 52.6 percent. (For details of the role of Japanese banks in recent U.S. corporate restructuring activity, see JEI Report No. 41B, October 27, 1989.)

In many situations the activities of Japanese banks, like those of their American counterparts, are not reflected as assets on the books. In this way the banks potentially are able to increase their profits without increasing their assets, making it easier for them to fulfill international capital/asset requirements that loom in 1992. For example, Japanese banks have increased their foreign exchange operations in this country; Dai-Ichi Kangyo Bank and Fuji Bank each announced in early 1990 that it would at least double its staff of foreign exchange traders in New York. Even with the additions both banks' currency trading staffs would be a fraction of the size of such U.S. multinational banks as Bankers Trust, which often earn as much as several hundred million dollars each year from trading.

Similarly, Japanese banks are getting more involved in swaps, a transaction where a bank typically collects a fee for switching the currency and interest rate terms among two or more securities, often to the benefit of each of the security issuers. Since the securities do not necessarily become bank assets, the capital adequacy ratio is not imperiled. Japanese banks also are active in the arcane world of standby letters of credit, essentially guarantees that a firm raising money by issuing securities will make payments. In return for this "insurance," the bank collects a fee. While information about this market is sketchy, Japanese banks reportedly held 44 percent of the California market in 1988.[9]

The Future: New Problems?

Letters of credit may not be a household term, but the concept is understood at least vaguely on Capitol Hill. In May of this year Rep. Frank Annunzio (D, Ill.), the chairman of the House Banking subcommittee on financial institutions, shot off letters to Treasury Secretary Nicholas Brady and Commerce Secretary Robert Mosbacher complaining that "in the letter-of-credit market for municipal securities in the United States, the Japanese dominate the market and

[9] Zimmerman, op. cit., p. 9.

have driven out domestic banks almost completely."[10] Mr. Annunzio cited letters of credit as an example of where he suspected that financial services "dumping" could be occurring. He urged Messrs. Mosbacher and Brady to discuss such problems in multilateral trade talks on services, such as those that form part of the Uruguay Round of the General Agreement on Tariffs and Trade.

Mr. Annunzio's use of the term "dumping" obviously was important, especially since he used the statutory definition of the word. Under this concept merely undercutting the price of a rival or driving competitors out of a market is not sufficient to prove dumping, which depends on injury as well as both price and cost considerations. Since firms found guilty of dumping can be assessed penalties, Mr. Annunzio was raising the specter of retaliation against Japanese banks for their pricing of products in the United States. Of course, many municipal governments have benefited from low rates for letters of credit and the willingness of Japanese banks to lend and would rather that Congress expand the powers of domestic banks than permit restriction of foreign banks.[11]

Mr. Annunzio soon may have an opportunity to address a related question. A measure that could, if enacted, limit the activities of Japanese banks in this country cleared the Senate Banking Committee in late May. Sen. Donald Riegle (D, Mich.) and Sen. Jake Garn (R, Utah), the committee's chairman and ranking Republican, respectively, have cosponsored the Fair Trade in Financial Services Act, which would establish a procedure for denying permission to establish or expand operations to financial institutions from countries that do not open their markets to comparable U.S. firms, mainly banks and securities companies. Given the current anxieties on Capitol Hill and the apparent dominance of Japanese institutions among foreign banks in the United States, few doubt that Japan was the target. Most remaining uncertainty evaporated when the Senate panel accepted an amendment submitted by Sen. Christopher Dodd (D, Conn.) that was interpreted as exempting financial firms from the European Community. Among the 10 countries with the largest foreign bank presence in this country the measure apparently could affect only Japan, Canada, Hong Kong, Switzerland and Israel. Prospects for passage in the Senate are considered fairly good, less so in the House. The Bush administration testified vigorously against the bill, but some Hill watchers believe the White House could change its mind.

The Riegle measure, in essence, calls for what is known as "reciprocal national treatment." The United States under this doctrine would treat foreign financial institutions the same as domestic ones ("national treatment") only if U.S. institutions also get national treatment in other countries. The 1978 International Banking Act established national treatment -- without the reciprocity provision -- as the guiding principle of U.S. international banking policy.

[10] Letter from Frank Annunzio to Robert Mosbacher dated May 15, 1990, released by Rep. Annunzio's office.

[11] For example, see the testimony of Kenneth B. Dobson, executive vice president of the Detroit (Michigan) Downtown Development Authority, before the Committee on Banking, Finance and Urban Affairs' subcommittee on financial institutions supervision, regulation and insurance, "Oversight Hearing on Foreign Competition in the Banking Industry," May 14, 1990.

However, the 1988 trade act introduced the concept of reciprocal national treatment for primary security dealers. Pursuant to that law the Federal Reserve Board reviewed the treatment U.S. firms receive in Japan and elsewhere and decided in August 1989 against taking action against any foreign-controlled primary dealers in this country. (Japanese banks are among the foreign financial institutions that control primary dealers in U.S. government securities. For details, see JEI Report No. 34B, September 1, 1989.) The Fed, however, promised to revisit the issue. The Riegle measure, if enacted, would cover much more financial activity.

This spring the Fed signaled a readiness to take a tougher approach toward Japanese banks. Along with the Comptroller of the Currency, one of the agencies with which it shares regulatory responsibility over the nation's banking system, the Fed reportedly indicated a change in U.S. requirements as they apply to the branches of Japanese banks in this country that lend to loss-ridden American subsidiaries of Japanese firms. Either the parent of the borrowing firm will have to provide guarantees or else the bank will be required to maintain bad-debt reserves on a branch-by-branch basis. Japanese banks find the measure unusual, especially the close supervision of branch activities, and feel that compliance would raise management difficulties. Nihon Keizai Shimbun, Japan's top economic daily, made it the lead story on the day the news broke.

Not only do Japanese banks have to scramble to keep up with U.S. regulatory authorities and proposed U.S. legislation, but they face domestic problems that could affect their international activities. For fiscal 1989, which ended March 31, most large banks posted a rare decline in profits. The Bank for International Settlements' guidelines on capital adequacy call for Japanese banks to have total capital of at least 8 percent of assets by 1992. Lower profits, along with greater difficulty in selling new stock issues as a result of the weak Tokyo stock market earlier this year, have made additions to capital more difficult in the first half of 1990. Therefore, restraining the growth of assets has become a major part of the strategy for achieving this ratio. For this reason and because of the increased attention paid to the questions of Japanese banks in the United States, banks in Japan reportedly plan single-digit annual percentage increases in assets over the next several years at their U.S. operations. This means that lending will be relatively restrained; it also may mean increased efforts to build short-term profits.

Conclusion

These recent developments suggest that the expansion of Japanese banks in the United States may have peaked. In coming years, however, Japanese banks will become more important in this country across a wide range of financial services, especially those that do not put assets on the books. Much, of course, will depend on legislative developments in the United States and Japan. Substantial revision of the Glass-Steagall Act, the law that prohibits commercial and investment banks from entering each other's businesses, would open new opportunities for Japanese banks -- particularly long-term credit banks, such as Industrial Bank of Japan, Ltd. Some observers also feel that changing Glass-Steagall would have an even greater effect in reinvigorating U.S. financial firms vis-a-vis their Japanese and other foreign rivals.

Moreover, Japanese and other banks will get additional options as interstate banking continues to spread in the United States. On January 1, 1991

California will become the latest state to permit interstate banking on a reciprocal basis. As a result, banks from California -- including the subsidiaries of Japanese banks -- will be able to establish retail operations in virtually all states in return for the right of banks from the same states to set up affiliates in California. To date, the main activity of Japanese banks in this regard has been to shore up their California bases in anticipation of an expected invasion from East Coast banks. How the presence of Japanese banks in this country will play in Peoria when Japanese banks get the right to operate retail affiliates in that Illinois city remains to be seen.

For further information, contact Douglas Ostrom.

Ian Condry provided research assistance.

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The views expressed in this report are those of the author and do not necessarily represent those of the Japan Economic Institute.

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REPORT

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ILLEGAL FOREIGN WORKERS IN JAPAN

Summary

Illegal foreign workers in Japan, mainly from Southeast Asia, have increased rapidly in recent years. This influx, attracted by the country's second-longest postwar economic expansion, has raised serious concerns within the government and has led to a tightening of Japan's immigration law effective June 1, 1990. Pressure from Asia's newly industrialized economies and developing countries elsewhere for Tokyo to accept more foreigners indicates, however, that the changes in the immigration law will not fully solve the dilemma associated with foreign workers in Japan.

Neither government, industry nor labor has reached a consensus on this heated issue. Some experts believe Japan should defuse criticism that says the country's emphasis on its monoculture and single race limits its participation in the family of nations. They emphasize that the time is at hand for Japan to open its society and accept the various values of different people from abroad. This argument, helped by the human rights movement, is gaining acceptance by a majority of people. How the problem of foreign workers is addressed in the next few years will indicate the long-term direction of the Japanese economy, society and culture.

Growing Number of Illegal Foreign Workers

Figures from the Ministry of Justice, which administers the immigration law, show a drop in the last two years in the number of illegal female foreign workers in Japan, who formed the majority of illegal aliens in the early 1980s, and a rapid increase in the ranks of males (see Table 1). Most analysts attribute these changes to the recent construction boom, which requires more male workers, and to the strict enforcement of the immigration law as it relates to the entertainment industry, which encompasses such jobs as bar hostesses as well as performing arts.

Table 1: The Number of Illegal Foreign Workers

Year	Total	Men	Women
1984	4,783	350	4,433
1985	5,629	687	4,942
1986	8,131	2,186	5,945
1987	11,307	4,289	7,018
1988	14,314	8,929	5,385
1989	16,608	11,791	4,817

MOJ's numbers represent only illegal workers who were prosecuted; thus, 1989's total of 16,608 is considered only the tip of the iceberg. The estimated population of illegal workers now in Japan exceeds 100,000, almost double the ministry's guess a year ago. Justice officials figure that half of these people have been in the country for more than a year, suggesting that longer stays are becoming more popular.

A look at prosecuted illegal workers by country of origin (see Table 2) shows that the women come mainly from the Philippines, South Korea and Thailand, while the men are largely Pakistanis, South Koreans, Bangladeshis and Malaysians. An estimated 74 percent of the females works in the entertainment or prostitution-related industries. Jobs for illegal males are found mainly in construction (47.3 percent) and small factories (39.8 percent), where the foreigners work as machine tool operators. Pakistan, Malaysia and South Korea are major sources of unskilled workers for construction jobs; Pakistan and Bangladesh provide a significant portion of the foreign work force in factories.

Table 2: Illegal Workers by Country in 1989

Country	Total	Men	Women
Philippines	3,740	1,289	2,451
Pakistan	3,170	3,168	2
South Korea	3,129	2,209	920
Bangladesh	2,277	2,275	2
Malaysia	1,865	1,691	174
Thailand	1,144	369	775
China	588	316	272
Others	695	474	221
Total	16,608	11,791	4,817

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Concerned in the late 1980s about the multinationalization of Japan's foreign work force and the dispersion of illegal workers from Tokyo to other cities, the Justice Ministry consulted with some Asian countries in a bid to limit illegal emigration. Moreover, enforcement of the immigration law was stepped up. As a result of these efforts, the ministry succeeded in substantially stemming the inflow of illegal workers from the Philippines, Bangladesh and Thailand in 1989. Furthermore, the number of people refused entry into Japan because their passports or visas were not in order more than tripled last year, going from 765 to 2,607.

When 107 Chinese landed at a small island off Nagasaki prefecture in late May 1989, they portrayed themselves as political refugees from Vietnam. (Tokyo pledged in 1979 to take political refugees from Vietnam and provide educational and/or job opportunities for them, marking the only exception to the country's strict immigration law.) Although the arrivals looked Vietnamese, they could hardly speak the language. The authorities realized that they were Chinese farmers wanting to work in Japan. Afterward, immigration officials became aware of a continuous inflow of Chinese disguised as refugees and of others smuggled into Japan aboard Chinese cargo ships. Tokyo agreed with Beijing to send the apprehended arrivals back to China in the near future.

Other ruses used by illegal workers are to pretend to be students in language or technical training schools. The number of students whose disguises failed them jumped from 213 in 1988 to 465 last year. Chinese accounted for 63 percent of the 1989 figure and 76 percent of the increase.

Causes of the Illegal Inflow

Japan's second-longest economic expansion (see JEI Report No. 22B, June 8, 1990) has created a lure for workers with dim prospects in struggling Asian countries and those eager to learn the technical secrets of economic success. Furthermore, the governments of some Asian countries encourage people to work overseas as one means of coping with high unemployment rates. At the same time Japan's fast-rising standard of living has meant that many of the Japanese who in the past filled unskilled or semiskilled positions now have higher ambitions, forcing employers to scramble to find enough blue-collar workers. Pushed and pulled, Japan has witnessed a rapid influx of foreign workers, both legal and illegal, in recent years.

The latest Ministry of Justice statistics on legal foreign residents in Japan show that the number of Chinese increased by 53.2 percent between 1986 and 1988. The same trend was evident for Filipinos (up 70.3 percent), Bangladeshis (up 80.1 percent), Thais (up 77 percent) and Pakistanis (up 65.8 percent). Therefore, both the statistics on legal foreign residents and the estimated number of illegal aliens imply that as long as enormous economic differences remain between Japan and its Asian neighbors, foreign pressure for Japan to open its labor market to Asians will continue.

Changes in the Law

Japanese immigration regulations bar legal entry for job-seeking unskilled foreigners. That policy is very similar to the legal environment in the United States and European countries. Japan's emigration and immigration law, enacted in 1951, provides the legal basis for refusing entry to unskilled workers. However, the existence of an estimated 100,000-plus illegal residents in Japan indicates that the law has been ineffective in dealing with the rapid influx of undocumented workers. Late last year the Diet, at the urging of the Ministry of Justice, amended the law by shrinking loopholes for unskilled workers and expanding opportunities for skilled labor (see JEI Report No. 46B, December 8, 1989). The changes went into effect June 1.

In order to expand the openings for skilled labor, the modified law adds 10 more job classifications to the 18 previous types of vocations under which foreigners can work and stay in Japan (known as a "qualification of stay"). Immigration officials make sure foreigners have the proper passports and visas and that their purpose for coming to Japan to work fits one of the 28 "qualifications of stay" categories. To smooth immigration procedures the revised law allows the Justice Ministry to issue a certificate describing the "qualification of stay" before an applicant arrives in Japan, if he or she submits the proper documents in time.

Similar to this country's 1986 Simpson-Rodino-Mazzoli immigration act, which makes employers responsible for ensuring that their employees are legally eligible to work, Japan's amended immigration law revises the schedule of penalties and fines to prevent employers from intentionally hiring illegal workers. Both employers and intermediaries who promote the use of illegal workers can face up to three years of imprisonment or Y2 million ($13,300 at Y150= $1.00) in fines. This provision applies only to those who hire or promote the hiring of illegal workers after the June 1 implementation date. In early May rumors spread among illegal workers and their employers to the effect that both employers and illegal workers would be jailed or fined on conviction regardless of when the hiring took place. As a result of this groundless rumor, hundreds of illegal workers rushed into immigration offices in late May to request deportation. Although the rumors were incorrect, at least one Japanese government official regarded them favorably because they helped decrease the number of illegal aliens in Japan.

Foreigners who violate the immigration law do so in two main ways. Either they extend their stay in Japan beyond the officially permitted time and thus are working illegally or they violate the status of their visa and get a job that is not covered by their official "qualification of stay." Strong penalties were considered necessary to deter both types of circumvention.

In addition to the penalties, the amended law provides two more specific measures to facilitate strict enforcement. The Justice Ministry can issue a "work certificate" to legal foreign workers if they request one to get a job. Employers can check whether foreign job applicants are legal or not by asking to see their work certificate prior to hiring. The other enforcement mechanism is to stipulate the monthly minimum wage for each type of job category eligible for a "qualification of stay." The implementing rules and regulations issued May 20 listed the acceptable minimums. For example, a job classified as "entertainment," such as singing or dancing, requires monthly wages of more than Y200,000 ($1,333). Foreigners holding jobs in "investment or management," "medical service" or "study/education" need to be guaranteed a monthly salary equivalent to what a Japanese employee would get in the same job. The revised immigration law also makes it harder for companies that want to bring in foreign trainees (see JEI Report No. 34B, September 1, 1989).

The amended law alarmed not only illegal workers but also companies in industries that depend on illegal aliens to overcome domestic labor shortages, such as construction, fast food, textiles and machinery. Many small companies began to consult with lawyers on how to deal with these problems. Some decided to use foreign students, who legally can work part-time. Another circumvention draws on the limited pool of legal Japanese citizens who cannot speak Japanese. These people typically are second- or third-generation descendants of Japanese Brazilians and Japanese Peruvians who went to South America before World War II.

Brazil and Peru have a policy of giving citizenship to anyone who can prove through a birth certificate that he or she was born within their borders. This is similar to what the United States and Canada do. Japan's rules for granting citizenship are different. There, at least one of the parents must be a citizen to be able to register the baby's name with the government. (The United Kingdom and France have the same policy.) These requirements mean that the child of illegal aliens cannot get Japanese citizenship since Tokyo does not regard a birth certificate as sufficient for citizenship. In contrast, a child born overseas to Japanese citizens can get Japanese citizenship if its Japanese parent registers the baby's birth with the Japanese embassy in the country in which the parents are living.

In this way most Japanese Brazilians and Peruvians have dual citizenship. Since they are considered Japanese nationals, they easily can get a Japanese passport and can work legally in Japan. An estimated 200,000 Brazilians and 70,000 Peruvians have Japanese passports under such circumstances. Several Japanese newspapers recently carried articles about the decision of trade associations representing small Japanese manufacturers of textiles and nonferrous metals to send a mission to Brazil and Peru to investigate the possibility of hiring dual citizens on a long-term basis.

Pros and Cons of Illegal Workers

The government has maintained a policy of not granting unskilled foreigners permits to work in Japan. The rationale includes:

- Foreign workers will reduce employment opportunities for Japanese citizens and worsen job prospects for women, older workers and the disabled; this pool of potential workers has not been tapped fully.

- A rapid influx of unskilled foreign laborers without sufficient preparation might cause societal problems. Among the fears are more crime, a deterioration in the living environment in metropolitan areas, confusion in the area of government-provided benefits -- education, health insurance and social security -- and social friction between Japanese and foreigners.

- A policy of allowing unskilled foreign workers to enter Japan during periods of economic expansion and what the government sees as the corollary -- forcing them to leave during downturns -- is irresponsible.

Most labor unions have supported the government's view. Trade associations representing small and midsized companies, however, have a different opinion.

- There is no way to prevent all unskilled foreign workers from entering the labor market in Japan; the job opportunities available there and the economic differences between it and Southeast Asian countries simply are too great.

- Companies in the construction and entertainment fields and small manufacturers, all of which now hire illegal foreign workers, are not finding enough job applicants among the untapped labor pool of women, older workers and the disabled. Therefore, an increase in the number of unskilled foreign laborers will not reduce opportunities for these potential employees.

- The short-term prescription for the current labor bottleneck is to hire foreigners.

To deflate social concerns about an influx of foreign workers, small business groups in Japan have proposed that the government set up a new organization that would bring in unskilled foreign workers for a limited time and then send them home at the end of that period. This body would keep close track of the foreign workers and would be responsible for their wages, working conditions and emigration. The families of foreign laborers would not be allowed to come to Japan because of the desire to keep these workers from settling in Japan. A similar proposal by the Ministry of Justice (see JEI Report No. 39B, October 13, 1989) outlined on a much smaller scale plans for trainee programs. MOJ's organization would allocate trainees to companies and set conditions that companies must meet before they receive trainees. Moreover, the companies would have to agree to guarantee that the trainees would emigrate after finishing the program.

This idea stems from West Germany's experience. When that country faced a serious labor shortage in 1950, Bonn decided to arrange for unskilled laborers from Italy, Spain, Greece, Turkey, Portugal and Yugoslavia to work legally in West Germany. Officials expected the workers to return home after their work term expired. That did not happen. The work experience and skills gained by foreign workers during their supposedly limited employment made employers reluctant to let them go. The employees also wanted to stay in West Germany, where they had a secure, comparatively well-paying job. Foreign workers then began to send for family members and proceeded to settle in West Germany.

Experts estimate that at the end of 1987 West Germany had close to 1.5 million Turks, 600,000 Yugoslavs, 550,000 Italians, 280,000 Greeks and 1.7 million-plus people of other nationalities living there for a total of more than 4.6 million foreigners. They accounted for 7.6 percent of the total population. Social problems, including high unemployment and deteriorating housing conditions, are among the reasons given by the Bonn government for tightening its immigration policy in 1973 and passing a new law in 1983 to encourage foreign workers to go back to their countries of origin. The policy proposed by small Japanese businesses recognizes the problems encountered by West Germany and attempts to avoid making the same mistakes by strictly controlling foreign workers.

Academic circles are very critical of this idea. They reason:

- An organization such as the one proposed by small business groups would be costly and hard to manage. No organization can monitor more than 100,000 foreign workers spread out all over the country.

- From a foreign relations standpoint, if not a human rights perspective, allowing in large numbers of foreign workers when the domestic labor market is tight implies that they cannot easily be sent home during economic slowdowns. Neighboring Asian countries would regard such a massive deportation as the export of unemployment to them, and they are likely to condemn Japan as being selfish.

- The economic rationale for an international division of labor indicates that rather than workers going to where the jobs are, companies should move operations to where labor is abundant. Small companies that hire illegal foreign workers because they are willing to work for low wages should relocate to developing countries.

- The role of government is not to provide jobs for unskilled, low-wage foreign laborers but to extend opportunities to such workers to improve their skills through training and study. This function also would facilitate the transfer of technology to Third World countries.

In line with this last idea a cross section of Japanese government officials also feels that a critical task for Tokyo is deciding how to expand trainee programs for foreign workers. An advisory group to the Ministry of International Trade and Industry submitted a proposal at the end of May to double the number of trainees brought to Japan to 50,000 within two years. Concerned that the current trainee system is too rigid, the Ministry of Labor also has begun to consider how to relax the applicable regulations to increase the number of trainees. The Ministry of Justice, which administers the trainee program, is not opposed to the idea of increasing the number of participants. However, it thinks that the program should be strictly monitored and not be modified to allow unskilled workers to get into Japan disguised as trainees.

In contrast to the positions taken by government, big business, labor and the academic community, the Japanese public is more sympathetic to allowing foreigners to take jobs in Japan. A mid-October 1989 poll by Asahi Shimbun showed that 56 percent of the people surveyed agreed that more foreigners should be allowed to work in Japan under certain conditions; 68 percent replied affirmatively in the metropolitan Tokyo area. Among the conditions described in the poll were limitations on the number of years foreigners could work, restrictions on the types of businesses that could hire non-Japanese and a cap on the number of people allowed work permits. Furthermore, 45 percent of the respondents supported the idea of granting amnesty to current illegal workers. Only 13 percent and 6 percent admitted to concerns for, respectively, social instability and changed working conditions. People who have analyzed this poll say the results reflect Japan's lack of familiarity with the serious problems West Germany experienced with foreign workers.

Japan's major political parties have just started to address the issue of foreign workers. The Liberal Democratic Party, which has a majority in the Diet's lower house, began discussions on this subject in the committee on small and medium-sized companies May 29 and in a special committee on foreign workers May 30. The LDP's position is said to be sympathetic to small and midsized businesses, which recently have been hamstrung by a severe shortage of unskilled labor. Party experts have suggested the possibility of expanding the training system to provide more unskilled foreign workers for these firms. They contend that some types of jobs classified as unskilled in Japan are regarded in developing countries as jobs that require technical skills. Since one of the objectives of Japan's foreign aid program is to transfer technological know-how to developing countries, an expanded definition of skilled labor would benefit both foreign workers and small Japanese companies involved in their training. The LDP has no timetable for a recommendation on this issue.

The Japan Socialist Party said last year that it is necessary to draft medium and long-term plans that take into account the increasing internationalization of Japan's economy. This statement was criticized as too ambiguous since it gave no clue whether the party was for or against the entry of more foreign workers. Other opposition parties, like Komeito and the Democratic Socialist Party, generally are opposed to the idea of accepting unskilled foreign workers in the belief that such a stance protects the interests of Japanese labor. However, no party is ready to outline its official position. Given the complexity of the issue, it may be quite awhile before Japan's major parties take a stand.

One of the more radical ideas to be proposed came from an advisory group to the Economic Planning Agency in April 1990. Pointing out the difficulty the Justice Ministry has in enforcing a restrictive immigration policy given the current world economic and political environment and noting the drawbacks to small business's proposal for an organization to handle unskilled foreign laborers, the EPA group offered a third suggestion. Under this plan Tokyo would extend job opportunities, including the trainee program, by relaxing the "qualification of stay" for people from developing countries. To integrate these workers into Japanese society the government would provide language education, knowledge about the Japanese community and Japanese history, health care and other assistance to ensure them a decent standard of living.

The "integration" approach is considered desirable and beneficial for both Japan and foreign workers. Since the small number of legal immigrants already in the country are treated like Japanese in the areas of education, social security and health insurance, this approach, its backers hope, would raise the social status of legal foreign workers (including trainees) to the same level as that of immigrants as well as increase the number of foreign workers. The EPA plan still sets limits, however, and would treat illegal, unskilled workers differently because they are considered to be a disturbance to society.

Prime Minister Toshiki Kaifu's government established a cabinet-level committee last December to monitor implementation of the revised immigration law and to draft a more comprehensive policy. This group, which includes representatives of 17 government organizations, is to coordinate the different approaches of various ministries and agencies and to try to speak in one official voice as soon as possible.

Conclusion

Japan is not alone among industrial countries in having adopted and maintained an immigration policy tailored to its perceived economic and social requirements. Moreover, just as other nations, like West Germany and the United States, have tightened immigration recently, so has Japan. But one clear difference exists between Japan and other advanced countries: the number of foreign workers represents a miniscule share of the total population. Therefore, the social and the economic impact of foreign workers is significantly different in Japan than in this country or Western Europe.

Foreign workers pose not only economic problems but also social and cultural dilemmas. The closed nature of Japanese society creates even more conflict with proposals for greater foreign worker access to the labor market. Haruo Shimada, an economics professor at Keio University, says that Japan cannot avoid letting in more foreign workers as it internationalizes. Given the world's increasing interconnectedness, he notes, society everywhere inevitably will become more open. By accepting different value standards brought by foreign workers, Japan might become more like other countries and, in doing so, could remove the source of international conflict that stems from perceptions of its uniqueness. The Asahi Shimbun poll from last fall suggests that a majority of Japanese generally agree with this thesis. Disagreements about how and when to open Japanese society to foreign workers imply that an answer will be neither easy nor forthcoming in the near future.

For further information, contact Hideo Takahashi.

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The views expressed in this report are those of the author and do not necessarily represent those of the Japan Economic Institute.

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REPORT

A Two-Part Report: A and B

NO. 23B
June 15, 1990

Japan Debates Merits Of Payments Surplus 1

Government Advisory Groups
Propose Reduced Working Hours 4

Kaifu Redirects Attention
To Foreign Policy Matters 5

House Passes Bill Relaxing Antitrust Laws
For Joint Production 7

Notes: FY 1990 Budget;
Japan's FY 1989
Foreign Direct Investment 9

Statistical Supplement 13

Japan Debates Merits Of Payments Surplus

After Japan has spent years trying to reduce a bulging current account surplus, many in Tokyo have fallen under the spell of a new revisionist viewpoint. With analysts at home and abroad forecasting a global capital shortage for the next several years, some Japanese are questioning the wisdom of killing the goose of Japanese prosperity that laid the golden egg. Some foreign observers are worried that a reversal of Tokyo's policy of reducing the country's current account surplus could slow or stop government efforts to promote imports and liberalize domestic markets as well as exacerbate trade tensions with other countries. Such a reversal, however, is unlikely and unnecessary, even if Japan is to continue its role as the world's largest creditor nation.

Along with the U.S. current account deficit and the West German surplus, Japan's large current account surpluses have been branded by many economists as a disruptive factor in the global economy. Under intense foreign pressure in

Moreover, they say, the measure is inconsistent with U.S. attempts to eliminate the restrictive investment policies of other governments through multilateral negotiations, such as the Uruguay Round of the General Agreement on Tariffs and Trade. Reportedly, foreign investors concerned about the restrictions proposed by Rep. Brooks' bill unsuccessfully requested Speaker of the House Thomas Foley to remove the legislation from the House calendar.

The Thurmond bill is expected to be aired before the Senate Judiciary Committee's antitrust, monopolies and business rights subcommittee this summer. Congressional sources say that whether the benefits of the NCRA should be extended to joint production ventures with foreign participants is likely to be a sticking point as Congress works out a compromise. Given current congressional concern over lagging American competitiveness, many legislators probably will resist giving foreign companies the same breaks they are proposing for American firms. Yet Capitol Hill also is likely to weigh the benefits provided by foreign investment. As an indication of such concern the vote on the Brooks bill was conducted by voice rather than roll call to provide anonymity for legislators representing states where foreign investments are much welcomed.

Margo Grimm

Notes

FY 1990 Budget - The Y66.2 trillion ($441.3 billion at Y150=$1.00) general account budget for fiscal 1990 went into effect June 7 despite disagreement between the two houses of Japan's parliament. The House of Councillors, which is controlled by the opposition parties, rejected the spending plan drawn up by the government of Prime Minister Toshiki Kaifu and approved May 10 by the lower house where the Liberal Democratic Party holds sway. Japan's constitution stipulates that spending measures become effective 30 days after lower house approval regardless of any upper house vote. The 68-day delay before the fiscal plan took effect for the year beginning April 1 meant that the government had to compile two temporary budgets to fill the gap (see JEI Report No. 20B, May 18, 1990).

The issue that led to the delay, moreover, has not been settled. The LDP and the opposition parties will use the remainder of the current special Diet session to debate alternative proposals to amend the controversial 3 percent consumption tax. The LDP has introduced a bill that would exempt food, education and some other basic costs from the levy, while the opposition-sponsored bill would replace the consumption tax with specific commodity taxes. Since parliamentary procedures for the two bills cannot be completed in both houses by the June 26 end of the current special session, an extension will be necessary since both sides are eager to force a vote on the legislation. Given the likelihood that neither bill will gain the necessary approval of both houses (revenue measures are not covered by the constitutional rule of lower house precedence), the 3 percent tax will remain in place, unchanged. The issue is certain to come up in the next regular Diet session late this year unless the LDP can put together a majority in the upper house.

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Table 1: Japan's Foreign Direct Investment by Country, FY 1985-FY 1989

(in millions of dollars)

	FY 1985	FY 1986	FY 1987	FY 1988	FY 1989	Cumulative March 31, 1990
United States	$5,395	$10,165	$14,704	$21,701	$32,540	$104,400
Canada	100	276	653	626	1,362	4,593
North America	5,495	10,441	15,357	22,328	33,902	108,993
United Kingdom	375	984	2,473	3,956	5,239	15,793
Netherlands	613	651	829	2,359	4,547	10,072
Luxembourg	300	1,092	1,764	657	654	5,383
West Germany	172	210	403	409	1,083	3,448
France	67	152	330	463	1,136	2,899
Switzerland	60	91	224	454	397	1,829
Spain	91	86	283	161	501	1,546
Belgium	84	50	70	164	326	1,353
Italy	32	23	59	108	314	684
Europe	1,930	3,469	6,576	9,116	14,808	44,972
Indonesia	408	250	545	586	631	10,435
Hong Kong	131	502	1,072	1,662	1,898	8,066
Singapore	339	302	494	747	1,902	5,715
South Korea	134	436	647	483	606	3,854
Thailand	48	124	250	859	1,276	3,268
China	100	226	1,226	296	438	2,474
Malaysia	79	158	163	387	673	2,507
Taiwan	114	291	367	372	494	2,285
Philippines	61	21	72	134	202	1,322
Asia	1,435	2,327	4,868	5,569	8,238	40,465
Panama	1,533	2,401	2,305	1,712	2,044	14,902
Caymans	132	930	1,197	2,609	1,658	6,743
Brazil	314	270	229	510	349	5,946
Bahamas	298	792	734	737	620	3,338
Mexico	101	226	28	87	36	1,707
Bermuda	148	16	36	337	228	1,219
Netherlands Antilles	62	66	199	172	38	786
Peru	10	---	1	---	---	696
Latin America	2,616	4,737	4,816	6,428	5,238	36,855
Australia	468	881	1,222	2,413	4,256	12,394
New Zealand	23	93	121	117	101	694
Oceania	525	992	1,413	2,669	4,618	13,933
Liberia	159	289	267	648	643	4,301
Africa	172	309	272	653	671	5,275
Kuwait	34	41	54	20	32	1,415
Iran	0	---	---	1	1	1,006
Middle East	45	44	62	259	66	3,404
Total	12,217	22,320	33,364	47,022	67,540	253,896

Source: Ministry of Finance

Table 2: Japan's Foreign Direct Investment by Sector, FY 1985-FY 1989

(in millions of dollars)

	FY 1985	FY 1986	FY 1987	FY 1988	FY 1989	Cumulative March 31, 1990
Manufacturing Sector	$2,352	$3,806	$7,832	$13,805	$16,284	$66,127
Food Products	90	127	328	419	1,300	3,265
Textiles	28	63	206	317	533	3,203
Wood and Paper Products	15	57	317	604	555	2,654
Chemicals	133	355	910	1,292	2,109	8,649
Metals	385	328	786	1,367	1,591	9,261
Nonelectric Machinery	352	626	687	1,432	1,762	6,479
Electric Machinery	513	987	2,421	3,041	4,480	14,676
Transport Equipment	627	828	1,473	1,281	2,053	9,009
Other	208	435	703	4,051	1,901	8,932
Nonmanufacturing Sector	9,536	17,949	25,080	32,634	50,517	182,516
Agriculture and Forestry	12	15	97	162	151	1,205
Fisheries	42	52	44	94	47	678
Mining	598	669	511	1,013	1,262	15,211
Construction	94	250	87	309	646	2,089
Trade and Sales	1,550	1,861	2,269	3,204	5,148	25,159
Banking, Finance and Insurance	3,805	7,240	10,673	13,104	15,395	57,271
Services	665	1,560	2,780	3,732	10,616	23,375
Transportation	1,240	1,925	2,145	2,372	2,927	15,269
Real Estate	1,207	3,997	5,428	8,641	14,143	34,742
Other	322	379	1,047	3	180	7,515
Branch Offices	329	566	452	584	739	4,659
Other Transactions*	---	---	---	---	---	595
Total	12,217	22,320	33,364	47,022	67,540	253,896

*Certain overseas real estate transactions have been excluded from Japan's foreign direct investment data since December 1, 1980 because of changes in the Foreign Exchange and Foreign Trade Control Law.

Source: Ministry of Finance

Table 3: Japan's Foreign Direct Investment by Industry and Region, March 31, 1990

(in millions of dollars)

	North America	Europe	Asia	Latin America	Oceania	Africa	Middle East	Total
Manufacturing Sector	$33,529	$7,947	$15,591	$5,633	$1,919	$231	$1,276	$66,127
Food Products	1,485	311	1,049	234	177	8	0	3,265
Textiles	651	489	1,569	440	11	39	4	3,203
Wood and Paper Products	1,847	17	450	202	137	1	-	2,654
Chemicals	3,581	1,110	2,077	602	126	24	1,130	8,649
Metals	3,656	395	2,578	2,010	428	127	66	9,261
Nonelectric Machinery	3,277	1,339	1,387	393	70	1	11	6,479
Electric Machinery	8,686	2,016	3,348	536	66	8	15	14,676
Transport Equipment	4,453	1,352	1,326	1,070	786	17	4	9,009
Other	5,894	917	1,807	143	118	7	46	8,932
Nonmanufacturing Sector	73,935	35,556	24,183	31,153	11,945	5,040	705	182,516
Agriculture and Forestry	430	8	297	208	253	7	2	1,205
Fisheries	158	18	177	147	79	99	1	678
Mining	1,889	1,416	7,124	1,557	2,244	582	399	15,211
Construction	1,015	84	643	219	65	22	40	2,089
Trade and Sales	14,146	5,404	2,575	1,759	1,218	14	44	25,159
Banking, Finance and Insurance	16,998	21,258	3,588	13,715	1,554	37	123	57,271
Services	12,038	2,487	4,815	1,271	2,050	710	5	23,375
Transportation	411	157	982	10,873	142	2,702	2	15,269
Real Estate	24,637	3,669	2,351	200	3,816	69	-	34,742
Other	2,215	1,056	1,632	1,203	523	798	87	7,515
Branch Offices	1,044	1,430	654	46	62	1	1,421	4,659
Other Transactions*	485	38	37	23	7	2	2	595
Total	108,993	44,972	40,465	36,855	13,933	5,275	3,404	253,896

*Certain overseas real estate transactions have been excluded from Japan's foreign direct investment data since December 1, 1980.

Source: Ministry of Finance

STATISTICAL SUPPLEMENT

Trade and Payments Data

(in millions of dollars unless otherwise indicated)

	1988	1989	January-March 1989	January-March 1990	January 1990	February 1990	March 1989
Japan's Balance of Payments							
Trade Balance	$95,012	$76,917	$21,311	$14,572*	$1,079*	$5,491*	$8,002*
Exports (f.o.b.)	259,765	269,570	66,945	65,235*	18,164*	21,539*	25,532*
Imports (f.o.b.)	164,753	192,653	45,634	50,663*	17,085*	16,048*	17,530*
Current Account Balance	79,631	57,157	16,064	12,404*	-636*	4,907*	8,133*
Long-Term Capital (net)	-130,930	-89,246	-5,612	-16,428*	-2,869*	-7,969*	-5,590*
Overall Balance	-28,982	-33,286	23,954	-66	-4,525	5,216	-757
International Reserves (end of period)	97,662	84,895	99,353	73,496	82,717	80,443	73,496
Japan's Customs Clearance Trade							
Trade Balance	77,563	64,328	17,085	12,416	338	5,013	7,065
Exports (f.o.b.)	264,917	275,175	68,227	66,718	18,673	22,006	26,039
Cars	38,671	38,804	10,088	10,545	3,296	3,465	3,784
Steel	15,322	14,789	3,812	2,912	846	990	1,076
Imports (c.i.f.)	187,354	210,847	51,142	54,303	18,336	16,993	18,973
Crude Oil	18,852	21,544	5,147	6,917	2,244	2,307	2,366
Manufactured Products	91,838	106,111	25,588	27,230	9,328	8,518	9,384
Japan-U.S. Trade							
Trade Balance	47,597	44,943	11,127	8,936	2,196	2,968	3,772
Exports (f.o.b.)	89,634	93,189	22,726	21,664	6,207	7,131	8,326
Imports (c.i.f.)	42,037	48,246	11,599	12,728	4,011	4,163	4,554
Yen-Dollar Exchange Rate							
(average for period)	Y128.15	Y137.96	Y128.45	Y147.90	Y145.09	Y145.53	Y153.08
U.S. Trade							
Trade Balance	-118,526	-108,994	-24,477	-22,237*	-9,814	-6,209	6,214*
Exports (f.a.s.)	322,426	363,983	88,389	97,150*	30,496	30,921	35,733*
Imports (Customs)	440,952	472,977	112,866	119,387*	40,310	37,130	41,947*
U.S.-Japan Trade							
Trade Balance	-51,794	-49,002	-12,407	-9,602*	-2,860	-3,122	3,621*
Exports (f.a.s.)	37,725	44,584	10,399	11,963*	3,974	3,766	4,223*
Imports (Customs)	89,519	93,586	22,806	21,565*	6,834	6,888	7,843*

*Preliminary

STATISTICAL SUPPLEMENT

Japanese Economic Indicators

(percent change from year-earlier period unless otherwise indicated)

	1988	1989	January-March 1989	January-March 1990	January 1990	February 1990	March 1990
Discount Rate (end of period)	2.5%	4.25%	2.5%	5.25%	4.25%	4.25%	5.25%
Outstanding Money Supply	11.2%	9.9%	10.2%	11.6%	11.5%	11.8%	11.6%
Industrial Production	9.5%	6.1%	8.3%	1.8%	1.8%	3.2%	0.7%
Manufacturing Operating Rate	5.9%	2.2%	2.6%	0.3%	-1.0%	1.8%	0.1%
Number of Bankruptcies	-20.0%	-28.4%	-26.3%	-29.3%	-24.7%	-25.0%	-36.1%
Residential Construction Starts	0.6%	-1.3%	-5.6%	2.9%	6.3%	5.6%	-2.0%
Job Openings to Applications (ratio)	1.01	1.26	1.16	1.35	1.32	1.37	1.35
Nominal Wages	3.8%	4.7%	4.3%	4.9%	7.6%	3.9%	3.2%
Manufacturing Labor Productivity	11.5%	6.2%	9.9%	2.6%*	2.6%	n.a.	n.a.
Wholesale Prices	-1.0%	2.5%	0.2%	3.7%	3.7%	3.5%	3.9%
Consumer Prices	0.7%	2.3%	1.1%	3.4%	3.0%	3.6%	3.5%
Yen-Based Export Prices	-2.2%	4.4%	2.5%	6.6%	6.3%	6.0%	7.4%
Yen-Based Import Prices	-4.6%	7.7%	0.5%	12.9%	13.0%	11.8%	14.0%

*January of each year only.

For Japan's latest GNP figures, see JEI Report No. 13B, March 30, 1990.

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JEI

REPORT

A Two-Part Report: A and B

NO. 24B
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IN THIS ISSUE:

Debate On Consumption Tax Continues 1

Tokyo Tries To Rekindle Interest In Energy 3

Mosbacher Outlines Competitiveness Agenda On Capitol Hill 7

Nakayama, Baker Discuss Trade, Global Politics And Security Issues 9

Final SII Report: Race Against Time 10

Notes: Export Controls 12

Debate On Consumption Tax Continues

Now that the FY 1990 budget is in effect (see JEI Report No. 23B, June 15, 1990), the remainder of the current Diet session is focusing on alternative proposals to amend the 3 percent consumption tax. The Liberal Democratic Party, which has a majority in the lower house, wants to exempt food, education and other basic costs from the consumption tax, while the opposition parties have proposed replacing the consumption tax with specific commodity taxes. Neither plan is expected to clear the house in which proponents of the other plan have a majority. The LDP's faint hopes of edging the opposition parties out of their control of the upper house waned when the Japan Socialist Party won a June 10 by-election in Fukuoka prefecture. Had the LDP candidate won, upper house lawmakers representing some small parties plus an independent and Democratic Socialist Party legislators had been expected to join the LDP team (see JEI Report No. 20B, May 18, 1990). However, the solid victory for the JSP's Shigeko Mieno, who had campaigned on a platform urging abolition of the consumption tax, has reinforced the JSP's resolve to dismantle the tax.

increasing their prices 3 percent even though they do not remit the tax to the government. As a result, MOF is reportedly planning to propose a new, lower exemption level. What MOF decides to do, however, most likely will not take effect until the LDP and the opposition parties devise a more coherent approach to revising the consumption tax.

Hideo Takahashi

Tokyo Tries To Rekindle Interest In Energy

A recent flurry of government reports may signal the start of a campaign to rekindle the Japanese public's awareness of energy conservation. The reports call for renewed efforts to promote the development of nonfossil-fuel energy sources as well as conservation, particularly with regard to the residential sector where the growth of energy consumption is outrunning earlier predictions. The government campaign, however, faces many potential pitfalls.

Although Japan's attention to energy conservation rose to manic proportions in reaction to the twin oil crises of the 1970s, interest has waned under the miasmic influence of several years of strong economic growth and low global oil prices. As long as total economic output was growing faster than energy consumption -- showing that overall energy efficiency was improving -- energy policymakers were not overly worried about flagging concern for conservation. Ministry of International Trade and Industry officials estimate that between FY 1973 and FY 1988 the amount of energy consumed per unit of price-adjusted gross national product fell 36 percent. Recent data, however, reveal a reversal. Japan's energy consumption rose 5.7 percent in fiscal 1988 compared with overall real GNP growth of 5.3 percent. Government analysts predict that the economy's energy efficiency declined again in FY 1989.

No fewer than three MITI advisory bodies have submitted new energy demand forecasts and conservation plans within the past month. The nuclear subcommittee and the supply and demand subcommittee of the Advisory Committee for Energy, the Electricity Utility Industry Council and the Natural Resources and Energy Agency all agree that domestic energy consumption is outrunning previous forecasts. Compared with its previous long-term outlook (Table 1), the Advisory Committee for Energy now predicts that total energy requirements in the year 2000 will surpass what was previously projected for 2005 (see Table 2). The group estimates that residential use will be the driving force behind the overall growth of energy demand over the next 20 years (see Table 3). This is true particularly for electricity use. The Electricity Utility Industry Council report indicates that household electricity use will outstrip industrial consumption by the year 2010, reflecting an increasingly prosperous lifestyle (see Table 4).

If the projected growth of energy demand sounds high, it should be pointed out that every report includes significant reductions in consumption through new conservation measures. The Advisory Committee for Energy, for example, assumes that the energy-to-GNP ratio will improve by more than 30 percent over the forecasted interval. The Electricity Utility Industry Council expects an efficiency gain of better than 10 percent in the use of electricity over the life of its outlook. Technological innovations expected to increase energy efficiency include "intelligent" buildings that actively monitor and

Table 1: Long-Term Energy Outlook, October 1987

(in millions of units and percent share)

	FY 1986		FY 1995		FY 2000		FY 2005	
	Units	Share	Units	Share	Units	Share	Units	Share
Coal (mt)	103.9	18.3%	121.0	18.3%	136.0	18.7%	150.0	19.0%
Nuclear (kw)	25.8	9.5	41.5	13.4	53.5	15.9	65.0	18.0
Natural Gas (kl)	42.8	9.9	55.0	11.1	58.0	10.8	60.0	10.0
LNG (kl)	28.8	6.7	36.0	7.3	38.0	7.1	---	---
Hydroelectric (kw)	35.8	4.2	42.5	4.5	45.5	4.4	48.5	4.0
Geothermal* (kl)	0.4	0.1	2.0	0.4	4.4	0.8	6.0	1.0
Alternatives* (kl)	5.5	1.3	12.5	2.5	24.5	4.5	52.0	9.0
Oil (kl)	246.0	56.8	245.0	49.7	242.0	45.0	240.0	42.0
Domestic (kl)	0.7	0.2	1.3	0.3	1.9	0.4	---	---
LPG (mt)	16.2	---	18.0	---	19.0	---	---	---
Total* (kl)	433.0	100.0	490.0	100.00	540.0	100.0	580.0	100.0

*Crude oil equivalent.

Table 2: Long-Term Energy Outlook, June 1990

(in millions of units and percent share)

	FY 1988		FY 2000		FY 2010	
	Units	Share	Units	Share	Units	Share
Coal (mt)	114.6	18.1%	142.0	17.4%	142.0	15.5%
Nuclear (kw)	179.0	9.0	330.0	13.2	474.0	16.7
Natural Gas (kl)	46.1	9.6	65.0	10.9	80.0	12.0
Hydroelectric (kw)	86.0	4.6	91.0	3.7	105.0	3.7
Geothermal* (kl)	0.4	0.1	1.8	0.3	6.0	0.9
Alternatives* (kl)	6.2	1.3	17.4	2.9	34.6	5.2
Oil (kl)	276.0	57.3	308.0	51.6	306.0	46.0
LPG (mt)	17.4	---	22.0	---	23.0	---
Total* (kl)	482.0	100.0	597.0	100.0	666.0	100.0

*Crude oil equivalent.

Source: Ministry of International Trade and Industry

control energy use as well as new building materials and designs, better wiring, more efficient appliances and improved generation and distribution systems.

Also highlighted is more aggressive development of alternative energy sources, with a particular emphasis on nuclear power. The reports seek to capitalize on growing public concern over environmental issues, such as global warming, to bolster their arguments for nuclear power, cogeneration systems,

Table 3: Projected Energy Consumption, June 1990

(millions of kiloliters of crude oil equivalent; share of total in parentheses)

Sector	FY 1988	FY 2000	FY 2010
Industry	173 (53.2%)	194 (49.2%)	206 (46.5%)
Manufacturing	147 (45.1%)	164 (41.5%)	173 (39.1%)
Households	80 (24.6%)	110 (27.8%)	134 (30.2%)
Transportation	72 (22.3%)	91 (23.0%)	103 (23.3%)
Total	325 (100.0%)	395 (100.0%)	444 (100.0%)

Source: Ministry of International Trade and Industry

Table 4: Projected Electricity Demand and Supply, June 1990

(millions of kilowatt-hours; share of total in parentheses)

	FY 1988	FY 2000	FY 2010
Demand			
Industry	391.1 (58.2%)	475.0 (51.3%)	505.0 (46.7%)
Households	281.2 (41.8%)	452.0 (48.7%)	575.0 (53.3%)
Supply			
Electric Utilities	597.4 (88.9%)	830.0 (89.5%)	973.0 (90.1%)
Households	74.9 (11.1%)	97.0 (10.5%)	107.0 (9.9%)
Total	672.3 (100.0%)	927.0 (100.0%)	1,080.0 (100.0%)

Source: Ministry of International Trade and Industry

home generation systems and renewable energy sources, such as methanol (Table 5).

The advisory bodies are careful to point out that their projections could easily be upset by a number of developments beyond their control, the

Table 5: Projected Electricity-Generating Capacity and Deliveries, June 1990

(in hundreds of thousands of kilowatts and percent share)

	FY 1988		FY 2000		FY 2010	
	Units	Share	Units	Share	Units	Share
Capacity						
Nuclear	287.0	17.4%	500.0	22.0%	720.0	27.0%
Coal	111.2	6.7	296.0	13.0	400.0	15.0
Natural Gas	330.6	20.1	503.0	22.0	530.0	20.0
Hydroelectric	361.3	21.9	445.0	19.0	517.0	19.0
Geothermal	1.8	0.1	10.0	0.4	35.0	1.0
Methanol	---	---	---	---	10.0	0.4
Alternatives	---	---	11.0	0.5	57.0	2.0
Oil	556.3	33.8	512.0	22.0	402.0	15.0
Total	1,648.2	100.0	2,277.0	100.0	2,670.0	100.0
Deliveries						
Nuclear	177.6	26.6	329.0	35.0	473.0	43.0
Coal	63.6	9.5	156.0	16.0	163.0	15.0
Natural Gas	141.4	21.2	188.0	20.0	201.0	18.0
Hydroelectric	88.6	13.3	101.0	11.0	118.0	11.0
Geothermal	1.1	0.2	6.0	1.0	21.0	2.0
Methanol	---	---	---	---	4.0	0.3
Alternatives	---	---	3.0	0.3	25.0	2.0
Oil	194.4	29.2	163.0	17.0	105.0	10.0
Total	666.8	100.00	946.0	100.0	1,109.0	100.0

Note: Figures may not add up due to rounding.

Source: Ministry of International Trade and Industry

most likely being a third oil crisis. The Japanese public's increasing resistance to nuclear power is a major obstacle to achieving sharp increases in nuclear generating capacity, which would require another 40 nuclear plants to be added to the existing 38. (A handful are currently under construction.) The Advisory Committee for Energy's nuclear subcommittee reports that the average construction time from planning to power generation has risen from just under eight years in the 1970s to nearly 27 years today. Communities also expect long-term gains from having a nuclear power plant in their backyard, not just short-term compensation. The subcommittee calls for special attention to safety issues and to the problem of radioactive waste disposal to allay the public's concerns. Nevertheless, it is clear that the government has set ambitious goals in the energy area, a field where Japan could exert global leadership.

Jon Choy

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REPORT

A Two-Part Report: A and B

NO. 25A June 29, 1990

ECONOMIC REGIONALISM: AN EMERGING CHALLENGE TO THE INTERNATIONAL SYSTEM?

Summary

For the better part of five years there has been speculation that the international trading system is moving in the direction of regional blocs rather than global free trade. Even while 105 nations thrash out proposals to expand the rules of the General Agreement on Tariffs and Trade to new areas, many of the participants are involved in negotiations with a more local flavor or are pursuing strategies that lay outside the purview of GATT. Whether this move toward economic regionalism will result in formal agreements or merely lead to informal trade and investment patterns depends on a variety of political as well as economic factors. If regionalism does spread, it is more likely to result from the evolution of North-South relations than the deterioration of the traditionally strong economic ties among industrialized countries.

Introduction

Events of the past year have raised questions about the future of the international political and economic system. The liberalization of Eastern Europe and the move toward European unification have prompted many analysts to conclude that the era of superpower bipolarity is over. As such, some question the relevance of a U.S.-led Western alliance in a multipolar world and see in its place political/security blocs in Europe, Asia and the Western hemisphere. At the same time there is increased interest in whether the world economy is moving in the direction of regionalism and away from internationalism. Much of this speculation has been sparked by the troubled discussions aimed at expanding the rules of the General Agreement on Tariffs and Trade to new areas,

Japan Economic Institute 1000 Connecticut Avenue, N.W., Washington, D.C. 20036 202·296·5633

including services, investment and intellectual property rights, and strengthening existing GATT provisions. In other words, if the current GATT negotiations do not produce satisfactory results, some fear that nations will focus their efforts on achieving regional prosperity.

This could take two forms. First, regionalism might entail a turn toward trade pacts among neighboring countries. The earliest moves toward this type of formal regionalism by a major player -- the European Community -- actually began in earnest in 1985, the year before the meeting in Punta del Este, Uruguay that gave birth to the Uruguay Round of multilateral trade negotiations. EC 1992, as the community's plan for economic integration is known, represents a formally established regionalism, with shades of political as well as economic cohesion.

Second, regionalism may occur via a more informal division of labor and capital, structured along North-South dimensions. While this might not inhibit economic relations among industrialized nations to the same extent as formal relations, it might result in separate spheres of economic influence and production patterns around the world. Some analysts argue that this already is occurring in Asia.

Skeptics stress, however, that economic indicators provide no evidence that trade and investment flows are concentrating within regional pools. These analysts point, for example, to the strong trade relations among Japan, the United States and Europe. Moreover, they cite Japan's expanding investment presence in the United States and Europe as additional evidence that the world is not moving toward economic blocs. As such, they believe that predictions of economic regionalism are being offered with little substantive evidence -- or even plausible theoretical arguments. Yet, given the continuing international debate, both the formal and the informal regionalism scenarios deserve consideration.

Formal Regionalism: Free Trade Pacts

Speculation regarding economic regionalism initially focused on the possible emergence of trading blocs. Two factors in the 1980s sparked interest in the conclusion of formal trade pacts. The first was the European Community's 1985 agreement to eliminate among its members the remaining barriers to trade and investment. This decision raised fears in Washington and Tokyo that American and Japanese firms eventually might be denied access to the European market.

Growing frustration with the slow progress being made in the Uruguay Round of multilateral trade negotiations also prompted countries to look at agreements that involved fewer parties. Since tariff barriers around the world have been progressively lowered as a result of previous rounds, Uruguay Round negotiators are tackling much stickier problems, such as intellectual property rights, subsidies, services trade and agricultural policies (see JEI Report No. 25A, June 30, 1989).

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While the Bush administration has made the successful completion of the Uruguay Round its top trade-liberalization priority (see JEI Report No. 18B, May 4, 1990), it has not ruled out bilateral trade agreements, announcing in early June that the United States and Mexico were exploring the possibility of a free trade agreement. The White House's two-track approach is not new. At the same time that the Reagan administration was trying to get a new MTN round going, it was negotiating free trade agreements with Israel (1985) and Canada (1987). Moreover, a U.S.-Japan free trade pact generated a flurry of interest in Washington as well as Tokyo in 1988 (see JEI Report No. 44A, November 18, 1988), but neither government pushed to address the political and substantive obstacles facing such an agreement, particularly after April 1989 when the United States named Japan as a priority country under the Super 301 provision of the 1988 trade act.

The notion of bilateral or regional trade arrangements in the 1990s covers a wide range of interpretations. U.S. and European policymakers discuss free trade pacts under the overall rubric of GATT; that is, the agreements are portrayed as being consistent with the goal of creating an international free trade system. (While trading blocs are not forbidden under the GATT framework, they could pose problems if they raise barriers to countries outside the relationship or cover selective situations.[1]) Indeed, some have argued that bilateral agreements may be an intermediary step between the current situation and global liberalization -- although few have outlined the steps by which the transition would occur.

An alternate reaction to Europe 1992 and the U.S.-Canada Free Trade Agreement is that such pacts eventually will lead to a contraction of world trade. The severity of the Great Depression has been linked with the tendency of countries to establish preferential trade agreements and protect their own markets rather than pursue liberal international trade policies. However, this may be an extreme analogy. Even some of the analysts who foresee negative consequences from trade regionalism are reluctant to predict doom on the scale of the 1930s.

Massachusetts Institute of Technology economist Paul Krugman, for example, expects regional trading blocs to emerge, but he argues that this hardly will be disastrous for the world economy. He suggests that economic regionalism will not result in a significant loss of jobs since dislocated workers simply would move out of export-oriented industries and into industries that formerly were import-intensive. While this might lead to a loss of economic efficiency, Mr. Krugman predicts that it would amount to only about a 2.5 percent decline in this country's gross national product -- the rough equivalent of the 1982 recession.[2]

A Regional Pact in Asia?

Regardless of whether the emergence of free trade agreements is a negative or a positive development, their appearance does not necessarily indicate that economic regionalism is taking root everywhere. Those who believe that FTAs are an intermediate step in the globalization of world trade tend to look for evidence worldwide of forces leading to similar arrangements. While there is some indication that these arrangements are being considered in Europe and the Western hemisphere, the third leg of the tripod -- Asia -- has had virtually no movement toward a strictly intra-Asian free trade pact. Rather, all discussions of regional trade accords explicitly have included U.S. participation.

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[1] Jeffrey Schott, "The Mexican Free Trade Illusion," International Economy, June/July 1990, p. 34.

[2] Japan Economic Journal, May 19, 1990.

While a formal free trade agreement within Asia is unlikely in the near term, the concept of economic regionalism is at the root of a proposal to create a Pacific version of the Organization for Economic Cooperation and Development (see JEI Report No. 44A, November 17, 1989). Originally proposed by Australian Prime Minister Bob Hawke, the first meeting of the newly created Asian-Pacific Economic Cooperation Conference took place in November 1989. Participants in the initial session stated publicly, however, that APEC would not be a trading group. Still, the trade angle has implicit interest. There have been reports, for example in the Far Eastern Economic Review, that some Japanese officials believe APEC eventually may form one pole of a tripolar trading bloc system -- with the United States/Canada, Europe and Asia comprising the three primary trading groups.

The fact remains that APEC is not comprised simply of Asian countries but rather of countries on both sides of the Pacific -- including Japan, Australia, New Zealand, South Korea, members of the Association of Southeast Asian Nations, Canada and the United States. The diversity of the members makes it highly unlikely that APEC will move toward economic integration on anywhere near the scale of the European movement. Instead, the organization is more likely to serve as a forum for discussions of economic issues. As currently conceived, it will supplement multilateral forums, such as GATT, rather than replace them.

Thus, the regionalism question becomes more complicated. The existence of the U.S.-Canada FTA and EC 1992 provides physical evidence of at least a partially regional focus within two of the three "blocs" that allegedly are emerging. (Whether the regional focus will supplant the postwar economic internationalism is another question.) At the same time, though, no such formal arrangement exists in Asia. But is an informal regionalism developing there? Japan's growing influence in the area to the exclusion of other countries -- whether because of a conscious Japanese effort or just a waning interest on the part of non-Asian countries in the region -- might indicate a de facto form of regionalism.

"De Facto" Regionalism: North-South Relations

If the structure and the membership of APEC do not represent a formal attempt to move toward a Japan-led Asian trading bloc, it actually could be the flip side of the same coin, some analysts have suggested. That is, APEC might be at least partially a reaction against the increasing dominance of Japan in East and Southeast Asia. Thus, in this view, APEC is not only a response to the move toward European integration but also a reflection of the desire by the United States and some Asian nations to counterbalance Japan's economic strength in Asia.

This argument suggests that efforts toward formal integration or the conclusion of an Asian free trade pact are not essential to assess whether the world is moving toward economic regionalism. Rather, the dynamics of North-South relations are evolving in such a way as to create dependence by developing Asian countries on Japan's economic resources. Fear that economic linkages may translate into dependence leads to a certain amount of ambivalence by Asian countries about Japanese economic activities. Although Asian developing nations actively encourage Japanese aid and investment, they also are wary of the possibility that financial ties may evolve into Japanese hegemony.

Thus, the second type of regionalism does not hinge as much on the development of trading blocs, per se, but on the patterns of dependence and interdependence that are evolving among developed and developing countries. This involves a number of factors -- including the patterns of Japanese direct investment in Asia, the decreasing U.S. commitment to the area and the importance of Japan as the region's primary aid donor.

<ins>Investment</ins> - The extreme version of this argument is that the rise of Japanese investment in Asia will lead to a regional -- perhaps neo-imperialist -- "yen bloc" that will reinforce Japan's economic strength. A more moderate view considers Japanese direct investment in Asia as a harbinger of a regional division of labor. In this scenario the linkages among Southeast Asian subsidiaries of Japanese multinational corporations could shape the development of national industrial structures -- possibly squeezing out firms of nonregional industrialized nations, such as the United States.

There is some evidence that Japanese businessmen and policymakers are exploring the feasibility of a sort of division-of-labor strategy. According to the Far Eastern Economic Review, some Ministry of International Trade and Industry officials believe that intraregional trade may increase more rapidly if Southeast Asian countries avoid creating industrial structures that duplicate each other's efforts, which would force head-to-head competition. Indeed, this has been one of the major obstacles facing Asean's attempts to achieve regional integration: because the member countries' economies are so similar, they tend to compete with one another rather than seize opportunities for intra-Asean trade and investment. Thus, participants at APEC's first conference in Canberra agreed to conduct a study of ways to carry out an industrywide division of labor among member nations.[3]

Seen by some analysts as even more significant are the efforts of the Japanese private sector in creating a regional division of labor. In its 1987 white paper on international trade and investment, MITI noted the "growing tendency for Japanese industry, especially the electrical machinery industry, to view the Pacific Region as a single market from which to pursue a global corporate strategy." Moreover, the media have focused on the efforts of Japan's automotive industry to set up a series of cross-supply arrangements among its Southeast Asian affiliates. The idea is to take advantage of the economies of scale that can be reaped from eliminating duplicative efforts within Southeast Asian countries.

Thus, Mitsubishi Motors Corp. (which reportedly pioneered the division-of-labor strategy) has established an arrangement by which its Thai affiliate buys stamped metal parts and electronic components from a MMC joint venture in Malaysia. Similarly, in September 1989 Toyota Motor Corp. announced that it expected its Southeast Asian affiliates to reach trade volumes of $100 million by 1992 or 1993.[4] Toyota's plans include the manufacture of transmissions in the Philippines, diesel engines in Thailand and steering components in Malaysia. Nissan Motor Co., Ltd. reportedly has a similar division-of-labor scheme.

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[3] Far Eastern Economic Review, May 3, 1990.

The reaction of Southeast Asian nations, with the exception of Indonesia, thus far has been guardedly positive. Thailand, the Philippines and Malaysia have decided to participate in a "brand-to-brand complementation scheme" through which each will reduce its tariffs by no less than 50 percent on automotive components made by the other participants.[5] Although Japanese motor vehicle manufacturers originally planned to include Indonesia in the cross-supply arrangements, Jakarta as yet has not agreed to participate. This could be because Indonesia, with some of the lowest-cost labor among Asean nations, reportedly fears it would end up manufacturing labor-intensive, low value-added components. In this case, it might gain less from the scheme than other Asean countries. Moreover, this type of division of labor might have a negative effect on Indonesia's trade balance.

The efforts of Japan's automotive manufacturers have prompted some speculation that a regionwide motor vehicle industry is being created. Others have stressed, however, that these attempts to create a division of labor have not been replicated to the same extent by Japanese corporations in other industries. Too, Asian developing countries actively have sought investment by American and other foreign firms -- not only to gain additional capital but also to counterbalance the influence of Japan's private sector. To conclude from the efforts of the auto companies that Asia is becoming an integrated market dominated by Japan would be premature. Still, these initial efforts to implement a division-of-labor strategy have captured the attention of analysts who are attempting to gauge the likelihood that the world will evolve (or devolve) into economic blocs.

Economic Assistance - Aid is another area in which there is some ambivalence regarding Japan's role. The rising importance of Japan's development assistance to Asia is indisputable. Both the United States and the governments of developing Asian countries have encouraged Tokyo to expand assistance for Asian economic development. At the same time, Washington's commitment to the region has diminished as it has shifted its attention elsewhere. For example, at the beginning of the 1970s bilateral aid to Asian countries accounted for nearly 50 percent of all (bilateral, multilateral and unallocated) U.S. development assistance. OECD figures indicate that by 1987 the U.S. amount had dropped to about 10 percent. By contrast, bilateral aid to Asia in 1987 made up roughly 50 percent of total Japanese aid.

Moreover, Tokyo repeatedly has stressed that -- although it will attempt to expand its aid flows to other geographic regions -- Asia will continue to have a special place in Japan's aid program. Looking only at total bilateral flows, Asia consistently receives between 60 and 70 percent of Japan's annual aid disbursements. In 1988, for example, Asia received 63 percent of Japan's

[4] Far Eastern Economic Review, February 15, 1990.

[5] Ibid.

aid. Moreover, the dollar value of aid to Asia soared from $2.5 billion in 1986 to $4 billion in 1988 (see JEI Report No. 41A, October 27, 1989). In the latter year nine of Japan's top 10 aid recipients were Asian countries (see Table 1).

Table 1: Major Recipients of Japan's Official Development Assistance, 1988

(in millions of dollars)

Country	Amount
Indonesia	$985
China	674
Philippines	535
Thailand	361
Bangladesh	342
Pakistan	302
Myanmar (formerly Burma)	260
Sri Lanka	200
India	180
Egypt	173

Note: Net disbursement basis.

Source: Ministry of Foreign Affairs

Thus, while Japan's aid to Asia is expanding, alternative sources of development assistance appear to be drying up, as in the U.S. case, or they never were well-established. With a few exceptions European nations have demonstrated little commitment to providing economic assistance to Asia. The European Community traditionally has emphasized assistance for African, Caribbean and Pacific commodity-producing countries.

More recently, EC attention has been focused on Eastern Europe. For example, the amount of economic assistance the EC plans to allocate in 1990 to just two Eastern European countries -- Poland and Hungary -- is less than that slated for all of Asia, according to the Far Eastern Economic Review.[6] Too, some EC members (such as Spain) that view Asian developing countries as competitors have lobbied, thus far unsuccessfully, to slash aid to the region. At any rate, it appears safe to conclude that EC policymakers for the time are preoccupied with events in Eastern Europe. Again, this leaves Japan as the major supplier of development capital to Asia.

It is not a situation with which everyone is comfortable. The predominant presence of Japan as an Asian aid donor has fueled fears that Tokyo's influence in the region is becoming too strong. This is perhaps best illustrated by the nature of the controversy over the Asian Development Bank's proposed Asian Finance and Investment Corp. (see JEI Report No. 23A, June 16, 1989). Similar to the World Bank's International Finance Corp., AFIC would use ADB and private bank funds to make loans and take equity stakes in private companies in member developing nations.

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[6] Ibid.

The United States and some European countries have expressed concern that AFIC would give the Japanese financial community an even greater role in the rest of Asia. Japanese financial institutions originally planned to contribute roughly 40 percent of AFIC's initial capital. However, other industrialized countries, especially the United States and West Germany, pressured Japan to lower the figure to about 30 percent of the initial $130 million capitalization, while American and European firms agreed to contribute 30 percent, the ADB 25 percent and non-Japanese Asian financial institutions 15 percent (see JEI Report No. 31B, August 11, 1989).

The European Factor

A corollary of this North-South view of regionalism has been applied to the future of Europe. Specifically, some analysts have suggested that European events may proceed in such a way as to integrate Eastern Europe with Western Europe. Thus, a unified Europe eventually may include the members of the European Community, the European Free Trade Association and the Eastern European members of Comecon (Council of Mutual Economic Assistance). This argument suggests that EC countries will take a leading aid and investment role in Eastern Europe, while Japan and the United States will assume a less significant economic presence there.

Evidence for this argument remains fuzzy at best. The changes sweeping Eastern Europe are too recent to allow reliable predictions about the future of foreign economic activity in the region. Current indications are that Japanese firms like their American counterparts, remain cautious about committing money to Eastern Europe, despite the number of businessmen making fact-finding visits. Prime Minister Toshiki Kaifu has announced Tokyo's intention to assist Eastern European nations in their economic development -- suggesting that Japan has a special role to play since the situation in the region is comparable to Japan's postwar experience (see JEI Report No. 3A, January 19, 1990).

Despite the wait-and-see attitude of most Japanese and American companies, European policymakers are concerned that investment ventures in Eastern Europe will be used by Japanese and other non-European firms to acquire a foothold in an integrated EC market. French journalist Rene Pascal, for example, has asserted that, "[i]t is apparent that Japan wants to use Eastern Europe as a gateway into an integrated European Community."[7] The possibility that this will happen has caused some worries that EC countries will take action to cut off this form of access.

If this occurs, it is difficult to predict how much nonregional interest in Eastern Europe will be sustained. It is possible that Japanese and U.S. manufacturers will be attracted by some of the features of the Eastern European investment climate -- including wage levels that are lower than certain Asian countries, a capable labor force and government-provided investment incentives. However, Eastern Europe lacks a large pool of engineers and suffers from shortages of necessary parts and equipment. If the European Community restricts imports of products produced in Eastern Europe, it is by no means clear that Japanese and American firms will continue to show even the cautious interest that they have demonstrated thus far. If this occurs, the European Community likely will be the dominant actor in the region, thereby reinforcing the trend toward regionalism.

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[7] Japan Economic Journal, January 27, 1990.

Implications of North-South Regionalism

Although the argument remains largely in the realm of speculation, some political analysts are suggesting that the liberalization of Eastern Europe will create a pool of inexpensive labor for the Continent -- a characteristic that has been absent more in Europe than in other regions. In classical dependency terms this means that a "core" and a "periphery" will exist in all the potential trading blocs. Thus, the emerging "North-South regionalism" can be defined as a situation in which developing countries in Asia would grow ever more dependent on Japan; Eastern European nations rely on Western Europe for trade, aid and investment; and Latin American nations look primarily to the United States. Trade and investment opportunities among industrialized nations may not necessarily diminish, but the pattern of industrialized/developing country relations would be structured informally along regional lines.

Analysts who believe this scenario is a possibility have suggested that North-South regionalism could work to the economic disadvantage of the United States. While developing countries in all parts of the world face some economic hardships, those in Southeast Asia generally are considered to show the most potential. Anxious to join the newly industrialized economies (South Korea, Singapore, Taiwan and Hong Kong) are such Southeast Asian countries as Malaysia and Thailand, which already are being called the "new NIEs." Too, although the economies of Eastern Europe confront dire problems, the potential of an integrated Europe is huge. Conversely, the economic stagnation and the debt crises facing many Latin American nations have prompted some observers to suggest that closer U.S.-Latin American economic ties will not be nearly as advantageous to the United States as intra-Asian linkages will be to Japan. In this view economic regionalism might lead not just to a drop in global efficiency but to a relatively greater drop for the United States than for other industrialized countries.

Regionalism or Internationalism?

Japan's influence may indeed be strong in Asia, but this is not necessarily a sign of regionalism. An alternative explanation is that the entire world is becoming more interdependent. Indeed, skeptics of regionalism arguments stress that economic indicators give no reason to believe that Asian countries are primarily dependent on Japan, except perhaps for aid.

Although Table/2 indicates that Asean nations conduct roughly 50 percent of their trade within Asia, only Indonesia appears to rely more heavily on Japan than on other industrial countries for exports and imports. Looking only at trade statistics, however, begs a question: how tight are the ties that are created by trade among Japanese-affiliated companies in developing Asian nations? It is very difficult to gather the data to answer this question, but a look at the structure of foreign investment in Asian countries may offer some insight as to the dependence of Asian countries on Japanese capital.

Table 2: Breakdown of Asean Trade Flows by Region, 1988*

Country	Japan	United States	Europe	Other Asia
Indonesia	34.8%	14.5%	16.4%	23.6%
Malaysia	19.6	17.5	14.1	37.7
Philippines	18.5	27.4	15.9	24.8
Singapore	15.6	19.5	14.7	37.3
Thailand	13.6	18.3	18.9	28.8

*Excluding Brunei.

Source: International Monetary Fund, Direction of Trade Statistics Yearbook 1989.

Japanese direct investment is extremely important to Asia, especially to the more advanced Asean countries. Still, it has not replaced investment by other nations. Non-Asian countries continue to make new investments (and to expand existing ventures) in Southeast Asia -- although not to the same degree as Japan. Japan's influence is quite clear in the cases of Thailand and Malaysia. The Bank of Thailand reports that Japanese companies in the January-June 1987 period accounted for roughly 40 percent of foreign direct investment in the country, while the United States and Europe together made up some 25 percent of the total. In the case of Malaysia, Japan accounted for 31 percent of 1987 foreign direct investment; the United States and Europe together accounted for some 16 percent. In the Philippines, by contrast, the United States is by far the most important foreign investor. As of 1987 new U.S. commitments to the country continued to outpace Japanese investment; moreover, the figure for the United States topped the comparable number for Japan by a ratio of almost four to one.

Perhaps even more important is that Asian countries other than Japan are expanding their investment activities in Asean nations. The NIEs have been active in setting up manufacturing subsidiaries in Asia, especially in lesser developed Asean countries, such as the Philippines and Indonesia. No longer are Japan and the United States unquestionably the most important investors in these countries. In fact, press reports have noted that Japan now ranks third among foreign investors in the Philippines -- after the United States and Taiwan. Thus, while intraregional ties form the core of Southeast Asian economic activities, it is by no means clear that Asian developing countries must depend primarily on Japan for private capital.

Nor is it obvious that the NIEs will limit their economic activities to the Asian region. Non-Asian countries -- especially the United States -- already are major export markets for Taiwan, South Korea, Singapore and Hong Kong. There also is some evidence that these countries are getting ready to take advantage of the opportunities emerging in Eastern Europe. According to the Japan Economic Journal, Singapore's Haw Par Brothers Pte Ltd. already has announced plans to set up a joint venture in Poland to import copper and aluminum from there. While it is too soon to tell how extensive such ventures will be, this example at least indicates that Asian firms are not thinking in strictly regional terms.

Conclusion

Arguments regarding economic regionalism remain highly speculative at this point. While seemingly embracing a more regional focus, Europe has not abandoned its links with multilateral forums. And although the United States has concluded two bilateral FTAs, Washington policymakers have stated explicitly that multilateral approaches remain paramount. Bilateral agreements are viewed as supplementing, not replacing, global trade arrangements. Moreover, there is virtually no evidence that Japan is abandoning its economic ties with the United States and Europe in favor of its Asian neighbors -- either through formal regional agreements or via a more gradual shift in trade and investment patterns. Nor is there evidence that Japan now is being locked out of international trade and investment opportunities.

As for the emergence of regionalism structured along North-South lines, the ballot is still out. Unlike the question of formal regional agreements -- where Europe and the United States have been more active than Japan -- evidence for informal North-South regionalism is cited more often in connection with Asia than Europe or the Western hemisphere. The situation in Europe is too new to reliably predict the evolution of relations between Western and Eastern Europe. In the Western hemisphere, there have been conscious attempts by the United States and Latin American countries alike to prevent the growth of regionalism or dependency by drawing on nonregional capital for investment and aid. Tokyo's 1987 plan to recycle a portion of its current account surplus to debtor nations was formulated initially with Latin America in mind (see JEI Report No. 41A, October 30, 1987). Too, the evolution of the Brady Plan for debt relief involved much more hands-on participation by Tokyo than did previous attempts to resolve the problem (see JEI Reports No. 38B, October 7, 1988, and No. 9B, March 3, 1989).

Even in Asia economic patterns are far from clear. Asean members do rely heavily on regional markets, investment capital and development assistance. However, the emergence of the NIEs as players in the region is likely to give Asean members opportunities to diversify foreign sources of capital beyond Japan and non-Asian industrialized countries. This presumably would allow developing Asian countries to avoid dependence on Japanese companies and the government for capital -- even if the United States and Europe focus less on Asia than they have in the past.

The fear that economic regionalism is on the horizon may indeed be worthy of attention, especially given the uncertainty regarding the future relationship between Europe and its nonregional trading partners. But it would be premature to assert that regionalism necessarily is on the rise. The evidence -- either in the form of trade statistics or trends in the structure of North-South relations -- simply is not there.

Still, the spotty evidence that does exist and that has given rise to economic regionalism arguments may serve to highlight the fact that more than one option exists for the international economic system. If regionalism is not a foregone conclusion, neither is global free trade. The outcome of such efforts as the Uruguay Round is sure to influence the direction -- one way or the other -- in which the international economic system moves.

For further information, contact Eileen M. Doherty.

Currently a doctoral student in political science at the University of California, Berkeley, Ms. Doherty was JEI's government relations analyst from July 1986 through July 1988.

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The views expressed in this report are those of the author and do not necessarily represent those of the Japan Economic Institute.

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JEI

REPORT

A Two-Part Report: A and B

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IN THIS ISSUE:

Japan's GNP Jumps In First Quarter 1

MOF Retreats
On Current Account Surplus Debate 4

Financial Reform Process Advances 5

Washington, Tokyo Commemorate
30th Anniversary Of Security Pact 7

Congress Continues To Wrangle
With Foreign Investment Issues 8

Notes: Super 301 Agreements 10

Japan's GNP Jumps In First Quarter

Chicken Little could have had a field day in Japan three months ago. The plummeting stock market suggested to some analysts that the Japanese economy was in deep trouble. But, as the fabled bird discovered, appearances can be deceiving. The Economic Planning Agency's recent release of the gross national product figures for the January-March period was the latest indication that the Japanese economy avoided serious short-run harm. Even though the stock market dropped substantially in the first three months of 1990, Japan's price-adjusted gross national product surged 2.5 percent over the October-December quarter -- a jump that translates to 10.4 percent growth on an annualized basis (see Table).

The latest GNP report was not without its surprises, however. Since the yen's appreciation between 1985 and 1988, rising domestic demand typically has offset declining net foreign demand by enough to yield positive overall quarterly GNP growth rates. In the January-March period the pattern was strikingly

Japan's Real Gross National Product at Constant (1980) Prices

(in billions of yen, seasonally adjusted, quarterly totals and rates of growth at annual rates)

	FY 1988	FY 1989	April-June 1989	July-September 1989	October-December 1989	January-March 1990
Gross National Product	Y334,968.8 (5.3%)	Y351,876.5 (5.0%)	Y340,561.8 (-3.0%)	Y350,436.1 (12.1%)	Y353,352.3 (3.4%)	Y362,202.3 (10.4%)
Personal Consumption Spending	185,317.8 (5.0%)	191,232.8 (3.2%)	186,600.8 (-3.9%)	190,316.4 (8.2%)	193,336.8 (6.5%)	194,396.8 (2.2%)
Private Residential Construction	20,686.8 (5.3%)	21,502.5 (3.9%)	20,855.0 (-8.8%)	21,328.5 (9.4%)	21,744.6 (8.0%)	22,190.1 (8.5%)
Private Fixed Nonresidential Investment	72,617.1 (17.3%)	84,584.1 (16.5%)	78,320.0 (2.6%)	83,374.1 (28.4%)	86,710.4 (17.0%)	89,067.7 (11.3%)
Change in Business Inventories	2,080.6 (*)	1,844.3 (*)	2,463.2 (*)	2,077.4 (*)	2,117.2 (*)	777.7 (*)
Government Current Expenditures	29,341.5 (2.2%)	29,909.1 (1.9%)	29,650.4 (0.0%)	29,732.0 (1.0%)	30,013.5 (3.8%)	30,236.0 (3.0%)
Government Fixed Investment	24,621.6 (1.2%)	24,543.6 (-0.3%)	24,540.4 (-2.2%)	24,205.1 (-5.4%)	24,509.2 (5.1%)	24,843.3 (5.6%)
Change in Government Inventories	-185.0 (*)	-35.9 (*)	371.8 (*)	63.4 (*)	-949.1 (*)	357.9 (*)
Net External Sector	488.4 (-33.7%)	-1,704.0 (-448.9%)	-2,239.8 (235.3%)	-660.8 (*)	-4,130.3 (*)	332.8 (*)
Exports of Goods and Services and Factor Income Received	61,457.7 (10.7%)	71,018.3 (15.6%)	65,824.7 (-3.2%)	70,171.1 (29.1%)	71,054.2 (5.1%)	77,114.1 (38.7%)
Imports of Goods and Services and Factor Income Paid	60,969.3 (21.4%)	72,722.3 (19.3%)	68,064.5 (10.0%)	70,831.9 (17.3%)	75,184.5 (26.9%)	76,781.3 (8.8%)

*Cannot be calculated or meaningless.

Source: Economic Planning Agency

different. Net exports accounted for 1.3 percentage points of the overall quarterly growth rate; without the slight offsetting effect of rising imports, the external sector would have contributed 1.7 points to the expansion.

In contrast, domestic demand -- while up -- was anemic, both in comparison to previous quarters and to net exports. Consumer spending, for example, rose only 0.5 percent from the previous quarter and accounted for a measly 12 percent (0.3 point) of overall growth despite making up more than half the total economy. Private plant and equipment spending rose 2.7 percent and chipped in 0.7 point of overall growth, an excellent performance by most standards but sharply lower than in the previous two quarters for this recent perennial champion.

Why the distinctly different pattern in the January-March quarter? An analyst attempting to find fault with Japanese economic policy might explain that once the domestic economy got into trouble, as reflected in the stock market's turbulence, Japanese companies solved their problems the old-fashioned way: they exported. If this analyst were sufficiently cynical, he or she might add that this turnabout explains the emergence in some quarters of Japan of a "surpluses are good for Japan and the world" argument concerning the size of Japan's global imbalance (see article in this issue).

Such an explanation would be seriously misleading. The rise in exports and the stock market turmoil are related but not in the way the above rationale assumes. Tighter monetary policy and the accompanying increases in interest rates during the first quarter were partly a response to the yen's prolonged softness as well as a contributing factor to the weakness in the stock market. The rise in exports was rooted in the weaker yen; it also reflected adjustments typical of the close of a fiscal year. Higher interest rates also may have been behind the sluggish state of domestic demand, including the slower expansion of plant and equipment investment. In addition, the decline in the stock market may have had a further adverse effect on capital spending. This argument suggests that the first-quarter GNP data essentially are a blurred picture of an economy in transition to higher interest rates and, possibly, a stronger yen. It does not suggest a linkage between weak domestic demand and export growth. Nor does it have unambiguous implications for the direction of the current account surplus.

Data for the fiscal year that ended March 31, released simultaneously with the quarterly figures, present a far clearer snapshot of the mid-1990 Japanese economy. GNP expanded 5 percent in real terms in FY 1989, far above the government's initial outlook of 4 percent growth and even higher than its late 1989 estimate of 4.6 percent. Domestic demand accounted for 5.7 points of the expansion, of which the private sector contributed 5.5 points. By contrast, net exports shaved 0.7 point off the growth rate. For the fiscal year the current account represented 1.9 percent of nominal GNP, down from 2.7 percent in FY 1989 and the peak of 4.5 percent registered in FY 1986. In other words, the current account declined by more than 50 percent relative to GNP between FY 1986 and FY 1989.

Most analysts believe that FY 1990 will not look that different from FY 1989. Some experts have trimmed their expected growth rates from those made in late 1989 and early this year. (For details of the earlier forecasts, see JEI Report No. 8A, February 23, 1990.) Industrial Bank of Japan, Ltd., for example, expected 4.6 percent real growth for FY 1990 as of February; a May forecast reduced that to 4.2 percent, still above the government's expectation of 4 percent growth. IBJ anticipates that the current account surplus will decline to $42.4 billion from $53.5 billion in FY 1989. If the bank's projections are accurate, the current account will continue to decline as a percentage of GNP. In short, the Bank of Japan's tighter monetary policy will be felt, but few catastrophic changes -- either from an American or a Japanese perspective -- are likely during the current fiscal year.

Douglas Ostrom

MOF Retreats On Current Account Surplus Debate

Criticism from other ministries as well as from overseas has dampened the Ministry of Finance's ardor toward a benign interpretation of a sizable Japanese current account surplus. An International Monetary Fund report issued in May gave weight to a perception that Japan needs to maintain a fairly substantial current account surplus to finance the new reconstruction needs of Eastern Europe as well as continue its role as a source of capital to developing and developed countries (see JEI Report No. 23B, June 15, 1990). Worried that this revisionist viewpoint would lead Tokyo to deemphasize structural economic reforms and import promotion policies, Bush administration officials harshly attacked its logic. In turn, concerned that the foreign backlash would reignite trade frictions, the Ministry of Foreign Affairs and the Ministry of International Trade and Industry downplayed the debate. Although the Finance Ministry is backing away from the new interpretation, data hinting that Japan's current account surplus may begin to widen will test Tokyo's mettle.

The International Monetary Fund, arguably the originator of the debate, since has stressed that its policy recommendation never was meant to justify the persistence of a big Japanese current account surplus. The IMF argued against reducing the surplus too rapidly, which might cause adjustment problems for the global economy, and against cutting the surplus by implementing measures that trim national savings. (In fact, the report prescribes savings-promotion policies to meet the needs of the world's capital-starved countries and to cure the macroeconomic imbalances of Japan, the United States and West Germany.) The report does not say, however, that Japan should try to perpetuate its large current account surplus.

Signaling a change of heart, Makoto Utsumi, vice finance minister for international affairs, reiterated June 21 that reducing the country's current account surplus remains a keystone of Japanese economic policy. He blamed the squabble on inflammatory newspaper reporting. An official change in policy never was considered, according to Mr. Utsumi. He added that advocates of the benign interpretation confused the necessity of promoting savings with the desirability of a current account surplus. Japan, he said, can reduce its current account surplus as well as export capital to the world. This position is supported by 1989 balance-of-payments figures showing not only that the long-term capital outflow is greater than the current account surplus but that the outflow increased while the surplus was falling.

A number of factors, however, point to the possibility that Japan's current account surplus will begin to widen in the near future. Government and

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REPORT

A Two-Part Report: A and B

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JAPAN'S FISCAL POLICY: SEEKING NEW DIRECTION?

Summary

In several important respects Japan's fiscal policy is at a crossroads. Having achieved in FY 1990 the government's objective of eliminating new issues of deficit-financing bonds, policymakers are debating new goals and priorities. Although the strong domestic economy provides a thick revenue cushion, new factors -- both domestic and foreign -- pose complex questions for fiscal planners.

Overview

Tokyo continued its steady course on fiscal policy into FY 1990, combining moderate increases in discretionary general account spending with a rapid reduction of new borrowing. The net effect of this policy stance, initiated in FY 1987, has been a more limited public-sector role in economic growth in recent years than at the beginning of the 1980s. Nevertheless, Tokyo has retained the ability to influence economic activity in specific areas through a willingness to reallocate general account funds when needed. This results in a chaotic pattern of increases and reductions among categories and in the same category between years. The supportive role of the Fiscal Investment and Loan Program continues to grow under the dual demands of greater public works spending and bigger foreign aid budgets.

General Account Expenditures - The gradual relaxation of fiscal austerity since FY 1986 can be seen from Table 1. The overall growth of general account spending has outpaced the nominal expansion of gross national product for the last three fiscal years and appears likely to do so again in FY 1990. As Table 2 shows, however, much of the growth has come from mandatory payments --

transfers to local governments and interest costs on the national debt. The expansion of discretionary outlays has been modest, reaching levels greater than the rate of inflation but less than the rate of overall economic growth in both FY 1988 and FY 1989.

One reason behind this divergence of discretionary and mandatory outlays is an informal four-year-old Ministry of Finance rule that calls for a freeze on capital outlays and a 10 percent cut in current operating costs. As is the norm, other ministries and agencies engage in tough negotiations with MOF to gain exceptions to this stringent spending guideline; results vary. Interestingly, no category has been reduced consistently since FY 1986 (although the budget for pensions has come close due to the decreasing number of veterans). Instead, a pattern of lean years then one good year is common. For example, social security outlays in FY 1988 jumped 14.3 percent but went up much less in other years.

Some items are politically sacrosanct. Defense and foreign aid have escaped MOF's budget ax because of strong foreign pressure for greater spending in these areas. Defense outlays have increased in the 6 percent range, while economic cooperation has been blessed with growth of 8 percent or more since FY 1987. (The figure for FY 1990 probably will be beefed up with a supplemental appropriation.) Other items have lost their sanctity. Food price supports were untouchable until the late 1980s. Energy programs lost favor in the mid-1980s but since have regained some ground. Even foreign pressure is not enough to guarantee steady growth. The budget for public works, for example, shows extreme swings despite consistent American pressure on Tokyo to spend more in this category.

The projected leap in the cost of servicing the national debt during the current fiscal year is illusory. The interest payment component of the debt service figure is expected to grow only slightly from FY 1989's level of just over Y11 trillion ($73 billion at Y150=$1.00). The extra monies, a little more than Y3 trillion ($20 billion), will be used to buy back some of the mountain of outstanding national bonds. It is likely from now on that the Ministry of Finance will redeem bonds whenever it can find the money.

General Account Revenues - The revenue plan shown in Table 3 indicates that the government believes it has achieved its FY 1982 goal of eliminating new issues of deficit-financing bonds by the start of the current fiscal year. The downward trend in this number since FY 1986 is clear, and the zero figure for new deficit bond issues in FY 1990 underscores the government's determination to finance operating expenses out of taxes and other revenue sources and borrow only to fund capital expenditures. Whether the government can keep its pledge is a question examined in more detail below.

A major reason for implementing the controversial 3 percent consumption tax, according to the ruling Liberal Democratic Party, was to reverse the increasing reliance on direct taxes. This clearly is not the case in either FY 1989, the year in which the tax took effect, or FY 1990. Direct taxes, which generated 54.8 percent of all receipts in FY 1986, for example, are expected to account for 65.1 percent of total revenues in FY 1990.

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The strength of the Japanese economy in recent years is the major reason direct taxes continue to provide an increasing proportion of revenues; corporate taxes, in particular, have increased much faster than the government anticipated, thanks to buoyant demand at home. But a close look at Table 3 shows another reason why Japan's dependence on direct taxes has not lessened. Revenues from the consumption tax are running well below projected levels, failing to make up for the elimination of various commodity taxes. According to the Ministry of Finance's latest figures, consumption tax collections had reached merely 34.9 percent of the projected first-year total of Y3.6 trillion or $24.1 billion. MOF analysts point to difficulties implementing the tax and to loopholes for smaller firms as the causes of the shortfall (see JEI Report No. 24B, June 22, 1990).

Table 3 also indicates that individuals once again are bearing more of the tax burden, a development counter to the government's consumer-oriented policies. Personal income taxes are predicted to account for 49.6 percent of direct tax revenues in FY 1990, up from the most recent low of 46.7 percent in FY 1988 but still well under FY 1986's figure of 55.6 percent. At the same time the corporate tax burden, which had reached 48.8 percent in FY 1988, is projected to fall in the current fiscal year to 45.7 percent. The forecasts for FY 1990 also show that individuals paying self-assessed income tax are expected to contribute less to personal income tax revenues than in FY 1989 -- 23.2 percent versus 25.1 percent. Conversely, people having taxes withheld will see their share rise from 74.9 percent to 76.7 percent. These figures are likely to make the average salaryman even more disgruntled with a tax system that allows the self-employed (a category that includes politically powerful farmers, small shop owners and professionals) to avoid taxes.

Fiscal Investment and Loan Program - Japan's capital budget continues to set records for overall spending (see Table 4). Budgeted outlays came to more than one-half of the initial general account for the first time in FY 1989 (53.4 percent) and top this level again in FY 1990 (an expected 52.2 percent). It should be noted, however, that FILP expenditures probably will fall below the 50 percent mark for FY 1990 when the supplemental budget is taken into account, just as they did in FY 1989 (48.7 percent). FY 1990 also is notable because the growth in FILP spending lags behind that of general account outlays for the first time in many years.

There are few surprises in terms of the allocation of FILP monies. Funds for housing and foreign economic cooperation continue to increase at a fast pace, an outgrowth of the government's commitment to increase Japan's social overhead capital and bolster foreign aid. The fast-growing outlays for "cash management" also fall into the public works area since much of the money flows into special construction projects. Other public works-related spending categories -- social infrastructure, land conservation, roads, communications and regional development -- show a mixed picture. An interesting new trend is the rapid growth of welfare-oriented spending, perhaps in preparation for the expected increase in the number of senior citizens over the next decades.

As for FILP funding sources, some points are worth noting. First, the direct link between the general account and the FILP budgets -- the Industrial Investment Special Account -- is becoming thin and possibly could be eliminated in coming years. MOF appears to be taking this tack more to trim the rise in the general account budget than to make the FILP budget independent; the transfer from the special account comprises less than 0.2 percent of total FILP revenues. An important point is the continuing role of funds controlled by the postal savings system. Postal savings and life insurance monies contributed 40.8 percent of all FILP revenues in FY 1989 and and are expected to cover 36.2 percent of spending in FY 1990. Contributions to the government-run pension fund and other government trust monies have increased their dominance as the single largest source of revenues, rising from 50.6 percent in FY 1986 to a projected 58.1 percent in FY 1990. With the government in control of the major sources of FILP funds, it would appear that stability is assured. MOF's advancing program of financial liberalization, however, threatens to shake up the system.

What Next?

The success of the government's austerity policies can be viewed from another perspective. Table 5 shows the sharp decline in reliance on deficit-financing bonds as well as the effort to hold construction bond issues in check. The current general account deficit has shrunk from a high of 35.4 percent in FY 1979 to just 10.7 percent in FY 1989 (in terms of revised budgets), with particularly impressive progress made over the last five years. Fiscal planners, goaded on by the steadily rising cost of servicing the outstanding debt, are not resting on their laurels. With fully one-fifth of general account funds devoted to debt service, the Finance Ministry has begun to focus on reducing the outstanding national debt.

The government's apparent success in eliminating deficit-financing bonds plus robust economic growth have helped push down the ratio of outstanding debt to nominal gross national product from its FY 1986 high of 43.4 percent to 40.4 percent in FY 1989 (see Table 6). Issues of refinancing bonds, however, have been growing as debt floated in the 1970s comes due; they will continue to increase as bonds issued in the 1980s mature. Despite the run-up in interest rates over the last year, refinancing this debt will cost less than, say, in the early 1980s. In FY 1989, for example, debt service costs were almost Y650 billion ($4.3 billion) lower over the life of the bond for every percentage point difference between the rate of return on the original bond and the refinancing bond that replaced it (in the 2 to 3 point range). Although headed in the right direction, the high total bond-to-GNP ratio is a source of concern to MOF, which has addressed this issue in its latest medium-term fiscal projection.

The government issues a new five-year fiscal projection every year. By comparing the projections for FY 1989 and FY 1990 (Tables 7 and 8, respectively) it appears that MOF is strengthening its austere stance. The newest projection envisions lower total expenditures for FY 1991 and FY 1992 than did the previous year's estimates. The latest projection for debt service costs, however, is higher than in the previous outlook. The same applies for transfers to local governments. Therefore, if total outlays are projected to fall while mandatory outlays are expected to rise, discretionary spending will have to be squeezed even tighter than before.

On the revenue side the Council on Fiscal Policy set four goals for the first half of this decade (see JEI Report No. 12B, March 23, 1990 for full details):

- Reducing total bond issues to less than 5 percent of total general account revenues by FY 1995. Since borrowing is expected to account for only 8.4 percent of total revenues in FY 1990, this goal should be within easy reach.

- Redeeming deficit-financing bonds ahead of schedule to cut debt service costs.

- Eliminating budget structures that hide the true size of the deficit and generally make the budget less transparent.

- Restraining the growth of overall government spending to less than the rate of nominal GNP expansion.

From MOF's viewpoint, therefore, the direction of fiscal policy for the first half of the 1990s will be toward greater austerity. Bonds will be redeemed before their 60-year maximum whenever possible, as shown in the FY 1990 budget. Funding for public works will rely less on bond issues and more on general account revenues. While MOF's game plan is subject to change through negotiations with other ministries and the LDP leadership, the ministry is likely to have the strongest hand on the tiller of fiscal policy. New foreign and domestic currents, however, may deflect the course of Japanese fiscal policy.

SII . . .

One of the new currents is an outgrowth of the recently completed Structural Impediments Initiative talks, which nominally aimed at removing structures in the American and Japanese economies that prevent the bilateral trade imbalance from narrowing. As the Bush and the Kaifu administrations tried to draft first an initial assessment of the discussions and then a final report, Japan's fiscal policy sprang up as a major bone of contention (see JEI Reports No. 15B, April 13, 1990 and No. 26B, July 6, 1990).

Washington's rationale for pressing Tokyo to boost public works outlays rests on their direct and indirect effects:

- Improved infrastructure - More housing, sewer systems, parks and other forms of social overhead capital would improve the quality of life in Japan. Likewise, better roads, airports, ports and communications systems would make Japan's markets more accessible to foreign manufacturers.

- Expanded construction market - Foreign firms can be expected to benefit from increased demand by Japanese contractors. U.S. engineering and architectural companies plus exporters of building materials and prefabricated homes should benefit.

- Expanded goods markets - New offices and homes must be furnished, equipped and decorated. More parks and leisure facilities should encourage Japanese spending on clothing and recreational equipment. Foreign products and services are competitive in many of these areas.

- Reduction of Japan's savings-investment imbalance - From a macroeconomic standpoint Japan's supply of domestic savings far outweighs its domestic investment needs. The discrepancy must be balanced by either government deficit spending or a current account surplus. (For a detailed explanation, see JEI Report No. 23B, June 15, 1990.) Washington hopes that expanded public works outlays both will break Tokyo's austerity policy (promote deficit spending) and reduce the savings-investment gap (promote consumption rather than savings).

In response, Tokyo raised the following points:

- Fiscal inflexibility - It would be extremely unwise for the government to set a floor for public works spending since this would severely limit its usefulness as a macroeconomic policy tool.

- Inflation potential - While such a spending floor would not present a problem when the economy is weak (since the government would want to raise spending to spur demand), it would pose a major inflationary threat if the economy already is growing strongly. With the economy registering a strong performance in the first quarter of 1990 and showing signs of having reached full employment, additional government spending at this time only would boost inflation.

- Capacity to serve as a source of savings to the world - Given the scarcity of savings in some developed countries (especially the United States) as well as in the Third World and in Eastern Europe, many Japanese feel it is shortsighted of the United States to demand that Japan reduce its savings pool.

Washington initially pushed Tokyo to commit itself to raising public works spending over the next 10 years to 10 percent of GNP from the current 6 to 7 percent range (6.7 percent in FY 1989). According to U.S. calculations, this would mean a total of about Y500 trillion ($3.3 trillion) spread over a decade. As the deadline for the final SII report neared, the Bush administration backed off somewhat, calling on Tokyo to promise only a "sufficiently large" investment plan in the final report. Some U.S. trade policymakers added a condition, however, suggesting that Tokyo set a five-year spending goal as well as a 10-year target; this would prevent the government from concentrating the spending in the last few years.

Japanese officials worked hard to pursuade their American colleagues that some flexibility was necessary. The United States would never consider asking any of its other allies to set such a specific policy, a number of Japanese complained, adding that Washington was prepared to commit itself only to reducing the federal budget deficit and was unwilling to set any specific targets or milestones. In late May Japanese negotiators offered to spend Y400 trillion ($2.7 trillion) in the 10 years from April 1991. The American SII team rejected this figure, arguing that it represented no change from the current situation vis-a-vis GNP. At the start of the final round of SII talks June 25, Tokyo suggested the Y415 trillion ($2.8 trillion) level. That number also was vetoed by Washington. Tokyo finally agreed to a budget of Y430 trillion ($2.9 trillion), a figure that should boost the ratio of public works outlays to projected GNP to over 7 percent.

The public investment spending target for the FY 1991-FY 2000 period represents a sharp increase over the Y274 trillion ($1.8 trillion) spent during the last 10 years. To achieve the Y430 trillion goal, public works spending will have to grow about 6.1 percent annually. Compared with the average annual expansion of 4.75 percent predicted in the government's current five-year economic plan (covering FY 1988-FY 1992) and the past decade's average annual increase of 1.2 percent, the magnitude of Japan's challenge becomes clear. It is not certain how MOF will respond to the new target but it surely will not abandon its fiscal goals completely.

. . . And Other Complications

Other new currents that could influence the course of Japanese fiscal policy also may be beyond MOF's control.

- Financial liberalization - Tokyo is nearing some critical decisions in its program to restructure domestic financial markets. On a general level moves to deregulate interest rates probably will push up the average. The government will be forced to offer higher rates of return on its bonds and notes in order to attract borrowers. This will raise the cost of new issues and the refinancing of old ones. It is not clear from MOF's budget estimates whether it has factored the impact of interest rate deregulation into its calculations of debt service costs.

More specifically, the restructuring of the postal savings system eventually must become part of Tokyo's financial liberalization program. Since the system controls a large chunk of the monies funding FILP outlays, the impact of restructuring on fiscal policy could be significant. If the postal system were freed to compete with commercial financial institutions, it would have to earn a higher rate of return on its investments than it now gets from purchases of government bonds and transfers to the FILP account. Whether FILP-funded projects can earn higher returns is debatable. A significant portion of FILP monies are used as foreign aid via the Export-Import Bank of Japan and the Overseas Economic Cooperation Fund. It would be paradoxical for these lenders to ask developing countries to pay higher rates of interest to satisfy Japanese savers. Investments in roads and other types of infrastructure would have to show a higher return, at least on paper. The Finance Ministry, nominally in control of the financial liberalization process, has not yet publicly aired its views on these matters.

- Pension fund reform - To meet the expected skyrocketing demand for social services by an aging population, Tokyo has opened a debate on how to reform its pension and trust fund system (see JEI Report No. 21A, May 25, 1990). Even more than the postal savings system, investments by the government pension and trust funds provide the bulk of monies for FILP spending. It is estimated that MOF's Trust Fund Bureau currently earns a return of 5.1 percent on the pension and trust funds it invests, including those in the FILP. This compares dismally with a 9 percent-plus return on privately managed pension funds. If the government is to fulfill its fiduciary duty to pensioners, it cannot accept the lower returns for long. Since FILP projects cannot generate competitive rates of return for the Trust Fund Bureau, this source of funding for the capital budget may be in serious trouble in the future.

- Special nontax revenues - Japanese fiscal planners have enjoyed a windfall in recent years from the sale of government-held shares of what were formerly public monopolies, primarily Nippon Telegraph and Telephone Corp. Sales of NTT shares have allowed MOF to devote an extra Y1.3 trillion ($8.7 billion) a year to public works spending starting in FY 1988. The public's love affair with the high-priced shares ended in 1989, however, when the third tranche was offered at a price less than the previous issue. The government was forced to offer fewer shares than originally planned. This year's across-the-board decline of shares listed on the Tokyo Stock Exchange has further darkened prospects for the proposed fall sale of NTT shares. Furthermore, the sluggish stock market has dimmed the outlook for the sale of government-held shares in other ex-public corporations, such as Japan Railways Group, the successor to the debt-ridden Japanese National Railways. In the short run MOF cannot count on these windfalls. Even in the long run it cannot count on them because of the limited number of shares the government owns or is planning to sell. How MOF will respond when these windfalls run out is an open question.

- Domestic politics - Perhaps the most troublesome and vexing developments arise from the ongoing domestic political battle between the LDP and the opposition parties. The LDP was having great difficulty pushing its expenditure and revenue bills through the Diet even before it lost control of the upper house of the Diet in last year's July elections. The ruling party was barely able to obtain Diet approval of the FY 1989 supplemental budget before the end of the fiscal year (see JEI Report No. 13B, March 30, 1990). The LDP then had to rely on the lower house's constitutional precedence in spending matters to put the FY 1990 general account budget into effect 68 days after the start of the fiscal year (see JEI Report No. 20B, May 18, 1990). Moreover, because this constitutional precedence does not extend to revenue measures or legislation dealing with such subjects as financial reform, MOF's plans for tax amendments or financial reforms could be completely frustrated. As an example, the government has been unable to implement the general account budget on time for the past several years, mainly due to opposition to tax measures (see JEI Report No.24B, June 22, 1989). Since the LDP's hopes of regaining control of the upper chamber via the ballot box are slim within the next decade (assuming alliances with opposition parties cannot be hammered out), the ministry's best-laid plans may be for naught.

Conclusion

The Finance Ministry can point to the rapid elimination of new deficit bond issues with justifiable pride. Fiscal austerity has not been a popular policy with other ministries nor with many influential domestic political groups and foreign allies. While coming ever closer to balancing the general account budget, Tokyo still has been able to expand financial support to meet its growing international responsibilities in the areas of defense and foreign aid. Moreover, the domestic economy is enjoying the second-longest expansion of the postwar era, and the outlook for setting a new record is good.

Having achieved all this, MOF now is groping for new goals. The latest medium-term fiscal plan contains modest, easily achievable objectives with regard to debt reduction, increased budget transparency and fiscal flexibility. But the plan was drafted before Tokyo agreed to the big boost in public works spending in the final round of SII talks. That pledge will make it much more difficult for MOF to continue its pitch for austerity, which already was increasingly out of step with Tokyo's publicly professed desire to bring Japan's standard of living up to levels commensurate with its economic power.

Complicating the fiscal debate are forces beyond MOF's control. The final SII report includes a follow-up mechanism, meaning that American pressure for a looser fiscal policy will not relent. Nominally in charge of financial reform and the restructuring of domestic financial markets, the ministry is being squeezed by powerful domestic interests and equally powerful economic forces released by the liberalization program's progress to date. MOF also is somewhat adrift as its expenditure and revenue plans are buffeted by recent domestic political storms. Finally, MOF (and the government in general) is finding itself increasingly less able to influence key aspects of economic activity, thanks in part to the success of its own deregulation program and efforts to reduce the size of the public sector. Volatile equity markets, for example, are endangering revenue plans. Despite this erosion of influence, fiscal policy still is a potent arrow in the government's quiver of policy tools. MOF will have to be more creative in responding to the new economic and political environment if this acuity is to be preserved.

For further information, contact Jon Choy.

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The views expressed in this report are those of the author and do not necessarily represent those of the Japan Economic Institute.

Table 1: Japan's General Account Expenditures (Revised), FY 1986-FY 1990*

(in billions of yen and percent change)

	FY 1986		FY 1987		FY 1988		FY 1989		FY 1990**	
Total Expenditures	Y53,324.8	1.1%	Y58,214.2	8.2%	Y61,351.7	6.3%	Y66,311.9	7.2%	66,236.8	9.6%
Social Security	10,090.3	2.6	10,321.8	2.3	11,801.4	14.3	12,474.2	5.7	11,614.8	6.6
Public Assistance	1,110.4	2.6	1,105.2	-0.5	1,062.0	-3.9	1,080.6	1.8	1,108.7	-2.9
Social Welfare	1,977.8	-3.8	2,033.2	2.8	2,146.3	5.6	2,309.7	7.6	2,405.6	7.8
Social Insurance	6,137.3	5.0	6,310.2	2.8	7,732.3	22.5	8,203.4	6.1	7,194.7	8.3
Health Services	497.2	7.1	512.3	3.0	500.7	-2.3	526.4	5.3	558.7	6.0
Unemployment Compensation	367.6	-3.4	361.0	-1.8	360.2	-1.2	354.1	-1.7	347.1	-2.0
Education and Science	4,886.6	-0.4	5,063.7	3.6	4,982.0	-1.6	5,075.3	1.9	5,112.9	3.6
Compulsory Education	2,414.9	-0.0	2,392.9	-0.9	2,463.5	3.0	2,475.5	0.5	2,485.2	4.1
Transfer to School Account	1,083.7	0.8	1,180.1	8.9	1,124.4	-4.7	1,184.8	5.4	1,199.8	5.2
Science and Technology Promotion	381.8	1.7	473.5	24.0	426.6	-9.9	453.9	6.4	475.5	6.1
School Facilities	350.0	-9.2	354.6	1.3	283.3	-20.1	262.7	-7.3	243.8	-7.3
School Aid	575.7	1.1	580.9	0.9	601.0	3.5	615.4	2.4	625.2	1.8
Student Loans	80.5	-3.7	81.7	1.5	83.3	2.0	83.0	-0.4	83.4	0.6
Public Works	6,946.3	0.3	7,428.0	6.9	6,683.0	-10.0	7,398.9	10.7	6,214.7	0.3
Erosion and Flood Control	1,101.4	1.7	1,221.9	10.9	1,059.4	-13.3	1,080.6	2.0	1,085.7	0.5
Road Improvement	1,826.3	-1.6	1,983.8	8.6	1,744.1	-12.1	1,782.6	2.2	1,788.1	0.3
Harbors and Airports	517.3	1.1	563.7	9.0	497.1	-12.8	511.5	2.9	514.6	0.6
Housing	940.2	1.3	964.4	2.6	930.3	-3.5	1,539.2	65.5	764.1	-0.0
Social Infrastructure	989.0	1.9	1,106.1	11.8	942.6	-14.8	954.9	1.3	957.4	0.3
Agricultural Infrastructure	886.9	0.9	963.7	8.7	852.4	-11.5	867.8	1.8	869.6	0.3
Forestry and Industrial Water Supplies	170.4	0.5	181.2	6.3	163.0	-10.0	169.1	3.7	157.8	-1.5
Disaster Reconstruction	503.5	-2.0	431.6	-14.3	483.8	12.1	482.3	-0.3	66.7	0.0
Reserves	11.3	5.6	11.8	3.6	10.4	-11.9	10.9	4.8	10.6	0.2
Pensions	1,850.1	-0.7	1,895.6	2.5	1,879.8	-0.8	1,855.7	-1.3	1,837.5	-1.0
Civil Servants	121.4	-2.7	122.2	0.7	118.1	-3.4	111.8	-5.3	107.8	-3.6
Veterans	1,562.6	-1.0	1,606.9	2.8	1,599.0	-0.5	1,588.5	-0.7	1,580.5	-0.5
Other Pensions	155.9	4.0	157.6	1.1	154.4	-2.0	147.4	-4.5	141.2	-4.2
Administrative Costs	10.3	-0.1	8.9	-14.3	8.4	-5.6	8.0	-4.8	8.0	-0.2
Local Finance	9,734.7	0.5	11,086.2	13.9	13,031.2	17.5	14,964.7	14.8	15,275.1	14.3
Local Allocation Tax	9,734.7	0.5	11,086.2	13.9	13,031.2	17.5	14,964.7	14.8	15,275.1	14.3
Interest Support and Special Grants	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
National Debt Service	10,664.4	4.8	11,851.4	11.1	12,030.7	1.5	12,089.8	0.5	14,288.6	22.5
Defense	3,338.0	5.3	3,507.8	5.1	3,728.3	6.3	3,969.9	6.5	4,159.3	6.1
Economic Cooperation	600.5	3.3	661.3	10.1	714.4	8.0	750.6	5.1	784.5	7.8
Small Business Assistance	225.6	6.5	263.2	16.6	257.6	-2.1	240.5	-6.6	194.3	0.0
Energy Support	570.5	-8.9	496.8	-12.9	458.4	-7.7	546.1	19.1	547.6	3.8
Food Agency Account	613.8	-11.7	688.2	12.1	480.4	-30.2	459.2	-4.4	395.2	-5.5
Miscellaneous	4,104.0	-5.6	4,292.2	4.6	4,304.6	0.3	4,987.1	15.9	4,162.2	2.6
Reserves	200.0	0.0	200.0	0.0	200.0	0.0	200.0	0.0	350.0	0.0
Industrial Investment Special Account	0.0	0.0	458.0	100.0	1,300.0	183.8	1,300.0	0.0	1,300.0	0.0

*Revised budget figures include the supplementary budget.
**Initial budget. Percent changes are based on the initial budget for FY 1989.

Source: Ministry of Finance

Table 2: Japan's Discretionary General Account Spending (Revised), FY 1986-FY 1990*

(in billions of yen and percent change)

	FY 1986		FY 1987		FY 1988		FY 1989		FY 1990**	
Total Expenditures	Y53,824.8	1.1%	Y58,214.2	8.2%	Y61,851.7	6.3%	Y66,311.9	7.2%	Y66,236.8	9.6%
Minus										
Debt Service and Transfers to Local Governments	20,399.1	2.7	22,937.6	12.4	25,061.9	9.3	27,054.5	8.0	29,563.7	18.1
Equals										
Discretionary Spending	33,425.8	0.2	35,276.5	5.5	36,789.8	4.3	39,257.4	6.7	36,673.1	3.7

*Revised budget figures include the supplementary budget.
**Initial budget. Percent changes are based on the initial budget for FY 1989.

Source: Ministry of Finance

Table 3: Japan's General Account Revenues (Revised), FY 1986-FY 1990*

(in billions of yen and percent change)

	FY 1986		FY 1987		FY 1988		FY 1989		FY 1990**	
Total Revenues	Y53,824.8	1.1%	Y58,214.2	8.2%	Y61,851.7	6.2%	Y66,311.9	7.2%	Y66,236.8	9.6%
Tax and Stamp Revenues	39,440.0	3.4	43,087.0	9.3	48,106.0	11.7	54,227.0	12.7	58,004.0	13.7
Direct Taxes	29,469.0	3.1	31,703.0	7.6	36,284.0	14.5	41,541.0	14.5	43,128.0	12.2
Income Taxes	16,393.0	6.6	16,188.0	-1.3	16,928.0	4.6	20,057.0	18.5	21,372.0	17.6
Withheld	12,979.0	5.8	12,303.0	-5.2	12,675.0	3.0	15,020.0	18.5	16,403.0	16.5
Self-Assessed	3,414.0	9.8	3,885.0	13.8	4,253.0	9.5	5,037.0	18.4	4,969.0	21.3
Corporate Taxes	11,725.0	-3.9	13,722.0	17.0	17,712.0	29.1	19,577.0	10.5	19,711.0	7.3
Inheritance and Gift Tax	1,351.0	34.6	1,793.0	32.7	1,644.0	-8.3	1,907.0	16.0	2,045.0	7.2
Indirect Tax Revenues	9,971.0	4.2	11,384.0	14.2	11,822.0	3.9	12,686.0	7.3	14,876.0	18.4
Liquor Tax	1,974.0	1.0	2,042.0	3.4	2,066.0	1.2	1,801.0	-12.8	1,914.0	6.3
Tobacco Excise Tax	986.0	11.8	1,012.0	2.6	1,011.0	-0.1	932.0	-7.8	957.0	2.7
Gasoline Tax	1,572.0	1.2	1,596.0	1.5	1,314.0	-17.7	1,365.0	3.9	1,423.0	4.2
Petroleum Tax	171.0	-56.8	190.0	11.1	290.0	52.6	438.0	51.0	453.0	3.4
Consumption Tax	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	3,618.0	100.0	5,320.0	47.0
Commodity Tax	1,627.0	5.8	1,686.0	3.6	1,906.0	13.1	0.0	-100.0	0.0	0.0
Securities Transaction Tax	981.0	62.7	1,766.0	80.0	1,800.0	1.9	1,234.0	-31.4	1,234.0	10.6
Motor Vehicle Tonnage Tax	506.0	13.7	486.0	-4.0	532.0	9.5	559.0	5.1	628.0	12.3
Customs Duty	478.0	-21.5	599.0	25.3	703.0	17.4	759.0	8.0	864.0	13.8
Other	214.0	-1.8	201.0	-7,1	227.0	12.9	131.0	-42.3	134.0	2.3
Stamp Revenue	1,462.0	7.0	1,806.0	23.5	1,973.0	9.2	1,849.0	-6.3	1,949.0	5.4
Monopoly Profits	7.6	15.2	6.0	-21.1	8.0	33.3				
Public Enterprise Receipts	16.7	5.0	17.5	4.8	16.7	-4.6				
Sale of Public Properties	134.5	-14.8	180.6	34.3	126.1	-30.2	2,373.9	57.8	1,339.6	42.6
Miscellaneous	2,289.7	1.6	1,586.7	-30.7	1,353.5	-14.7				
Public Bonds	11,495.0	-7.6	10,539.0	-8.3	7,967.0	-24.4	7,111.0	-10.8	5,593.2	-21.3
Construction	5,700.0	n.a.	6,880.0	20.7	6,196.0	-9.9	6,430.0	3.8	5,593.2	-13.0
Deficit-Financing	5,795.0	n.a.	3,659.0	-36.9	1,771.0	-51.6	681.0	-61.5	0.0	-100.0
Debt Consolidation Fund	0.0	0.0	458.0	100.0	1,300.0	183.8	1,300.0	0.0	1,300.0	0.0
Carryover Surplus	441.3	114.8	2,339.4	430.1	2,974.6	27.2	2,336.3	-21.5	n.a.	n.a.

*Revised budget figures include the supplementary budget.
**Initial budget. Percent changes are based on the initial budget for FY 1989.

Source: Ministry of Finance

Table 4: Uses and Sources of Japan's Fiscal Investment and Loan Program Outlays (Initial), FY 1986-FY 1990

(in billions of yen and percent change)

	FY 1986		FY 1987		FY 1988		FY 1989		FY 1990	
Total Outlays	Y22,155.1	6.2%	Y27,081.3	7.1%	Y29,614.0	9.4%	Y32,270.5	9.0%	Y34,572.4	7.1%
Housing	5,856.2	10.7	6,328.2	8.1	6,921.5	9.4	7,460.6	7.8	8,365.9	12.1
Other Social Infrastructure	3,694.5	12.6	3,998.7	8.2	4,450.9	11.3	4,371.3	-1.8	4,222.0	-3.4
Welfare	625.9	5.1	627.7	0.3	661.8	5.4	736.0	11.2	851.9	15.7
Education	678.2	-9.0	784.1	15.6	637.6	-18.7	520.2	-18.4	554.1	6.5
Small Business	3,700.0	-1.7	3,985.6	7.7	4,030.6	1.1	4,176.4	3.6	4,337.8	3.9
Agriculture	902.1	1.3	907.8	0.6	979.4	7.9	924.4	-5.6	876.0	-5.2
Land Conservation and Disaster Work	422.7	-10.6	493.0	16.6	409.8	-16.9	357.9	-12.7	328.5	-8.2
Roads	2,024.4	10.8	2,363.0	16.7	2,512.1	6.3	2,576.8	2.6	2,700.1	4.8
Transportation and Communications	2,015.1	14.3	2,264.1	12.4	2,229.9	-1.5	2,361.6	5.9	2,304.1	-2.4
Regional Development	566.1	10.7	657.7	16.2	652.2	-0.8	676.6	3.7	682.5	0.9
Industry and Technology	635.9	5.4	630.9	-0.8	687.2	8.9	758.7	10.4	796.5	5.0
Foreign Trade and Economic Cooperation	1,034.0	-7.2	690.5	-33.2	1,171.0	69.6	1,420.0	21.3	1,603.0	12.9
Cash Management	n.a.	n.a.	3,350.0	n.a.	4,270.0	27.5	5,930.0	38.9	6,950.0	17.2
Total Revenues	Y27,155.1	5.0%	Y31,081.3	14.5%	Y33,114.0	6.5%	Y34,570.5	4.4%	Y36,572.4	5.8%
Industrial Investment Special Account	61.5	95.9	144.3	134.6	91.2	-36.8	85.2	-6.6	64.1	-24.8
Trust Fund Bureau Fund	20,738.6	3.5	24,595.8	18.6	26,206.6	6.6	26,871.3	2.5	28,453.3	5.9
Postal Savings	7,000.0	9.4	7,900.0	12.9	7,900.0	0.0	8,500.0	7.6	7,200.0	-15.3
Pension Contributions	4,300.0	8.9	4,450.0	3.5	3,500.0	-21.3	4,310.0	23.1	5,540.0	28.5
Other Revenues	9,438.6	-2.5	12,245.8	29.7	14,806.6	20.9	14,061.3	-5.0	15,713.3	11.7
Postal Life Insurance Fund	3,145.0	21.5	3,941.2	25.3	4,409.4	11.9	5,614.0	27.3	6,055.0	7.9
Government-Guaranteed Bonds and Borrowings	3,210.0	0.0	2,400.0	-25.2	2,406.8	0.3	2,000.0	-16.9	2,000.0	0.0

Source: Ministry of Finance

Table 5: Japan's Current General Account Budget Deficit, FY 1970-FY 1990

(in billions of yen and percent of total spending)

Fiscal	Initial Budget								Revised Budget	
Year	Construction Bonds		Deficit Bonds		Total Bonds		Debt Service		Total Bonds	
1970	Y430	5.4%	0	n.a.	Y430	5.4%	Y290.9	3.7%	Y347	4.2%
1971	430	4.6	0	n.a.	430	4.6	319.3	3.4	1,220	12.6
1972	1,950	17.0	0	n.a.	1,950	17.0	455.4	4.0	2,310	19.1
1973	2,340	16.4	0	n.a.	2,340	16.4	704.5	4.9	1,810	11.9
1974	2,160	12.6	0	n.a.	2,160	12.6	862.2	5.0	2,160	11.3
1975	2,000	9.4	0	n.a.	2,000	9.4	1,039.4	4.9	5,480	26.3
1976	3,525	16.0	Y3,750	19.3%	7,275	29.9	1,664.7	6.9	7,375	29.9
1977	4,430	11.9	4,050	17.8	8,480	29.7	2,348.7	8.2	9,985	34.0
1978	6,050	13.6	4,935	18.4	10,985	32.0	3,222.7	9.4	11,285	32.8
1979	7,215	12.5	8,055	27.1	15,270	39.6	4,078.4	10.6	14,050	35.4
1980	6,785	11.5	7,485	22.0	14,270	33.5	5,310.4	12.5	14,270	32.7
1981	6,785	11.8	5,485	14.4	12,270	26.2	6,654.2	14.2	12,900	27.6
1982	6,516	11.5	3,924	9.5	10,440	21.0	7,829.9	15.8	14,345	30.2
1983	6,365	9.9	6,980	16.6	13,345	26.5	8,192.5	16.3	13,486	26.1
1984	6,225	9.8	6,455	15.2	12,680	25.0	9,155.1	18.1	12,781	24.5
1985	5,950	9.4	5,730	12.8	11,680	22.2	10,224.1	19.5	12,308	22.8
1986	5,700	8.9	5,246	11.3	10,946	20.2	11,319.5	20.9	11,495	21.4
1987	5,520	10.2	4,981	9.2	10,501	19.4	11,333.5	20.9	10,539	18.1
1988	5,690	10.0	3,151	5.6	8,841	15.6	11,512.0	20.3	7,967	12.9
1989	5,780	9.6	1,331	2.2	7,111	11.8	11,664.9	19.3	7,111	10.7
1990	5,593	8.4	0	0.0	5,593	8.4	14,288.6	21.6	n.a.	n.a.

Source: Bank of Japan and Ministry of Finance

Table 6: Japan's Cumulative General Account Budget Deficit, FY 1970-FY 1989

(in billions of yen and percent of nominal gross national product)

Fiscal Year	Construction Bonds		Deficit Bonds		Refinancing Bonds		Total Bonds	
1970	Y2,642.2	3.5%	Y168.8	0.2%	0.0	0.0	Y2,811.0	3.7%
1971	3,851.1	4.7	100.9	0.1	0.0	0.0	3,952.0	4.8
1972	5,818.5	6.0	0.0	0.0	0.0	0.0	5,818.5	6.0
1973	6,943.5	6.0	0.0	0.0	Y606.8	0.5%	7,550.3	6.5
1974	8,403.6	6.1	0.0	0.0	1,254.8	0.9	9,658.4	7.0
1975	11,178.4	7.3	2,116.9	1.4	1,677.7	1.1	14,973.0	9.8
1976	14,530.1	8.5	5,492.8	3.2	2,053.6	1.2	22,076.5	12.9
1977	19,280.8	10.1	10,253.5	5.4	2,367.9	1.2	31,902.2	16.8
1978	24,964.7	12.0	14,647.2	7.0	3,003.7	1.4	42,615.6	20.4
1979	32,181.7	14.3	21,065.7	9.3	3,003.7	1.3	56,251.1	25.0
1980	38,953.5	15.9	28,257.1	11.5	3,299.1	1.3	70,509.7	28.8
1981	45,149.7	17.4	32,916.3	12.7	4,207.3	1.6	82,273.3	31.7
1982	48,589.4	17.8	40,330.1	14.8	7,562.5	2.8	96,482.0	35.4
1983	51,366.3	18.1	47,059.9	16.6	11,268.4	4.0	109,694.6	38.6
1984	53,447.9	17.6	53,074.5	17.5	15,171.0	5.0	121,693.4	40.2
1985	52,830.3	16.4	57,306.0	17.8	24,295.0	7.6	134,431.3	41.8
1986	52,745.0	15.8	58,846.3	17.6	33,535.2	10.0	145,126.5	43.4
1987	51,923.4	14.8	56,803.0	16.2	43,082.8	12.3	151,809.2	43.2
1988	49,307.3	13.2	54,365.5	14.6	53,107.4	14.3	156,780.3	42.1
1989*	48,732.6	12.2	47,825.5	12.0	64,351.8	16.2	160,910.0	40.4

*Percent of GNP based on preliminary FY 1989 nominal growth of 6.9 percent.

Sources: Bank of Japan and Ministry of Finance

Table 7: Japan's Medium-Term Fiscal Projection, FY 1988-FY 1992

(in billions of yen and percent change)

	FY 1988		FY 1989		FY 1990		FY 1991		FY 1992	
Expenditures										
General Account	Y32,982.1	1.2%	Y34,080.5	3.3%	Y36,280.0	6.5%	Y37,480.0	3.3%	Y38,580.0	2.9%
					[36,820.0	8.0	38,600.0	4.8	40,320.0	4.5]
Current Expenditures	25,897.4	1.7	26,869.9	3.8	28,980.0	7.9	30,160.0	4.1	31,240.0	3.6
					[29,410.0	9.5	31,060.0	5.6	32,650.0	5.1]
Capital Expenditures	7,084.7	-0.4	7,210.6	1.8	7,300.0	1.2	7,320.0	0.3	7,340.0	0.3
					[7,410.0	2.8	7,540.0	1.8	7,670.0	1.7]
National Debt Service	11,512.0	1.6	11,664.9	1.3	14,380.0	23.3	14,870.0	3.4	15,050.0	1.2
Transfers to Local Government	10,905.6	7.1	13,368.8	22.6	14,210.0	6.3	15,130.0	6.5	16,090.0	6.3
Industrial Investment Special Account	1,300.0	0.0	1,300.0	0.0	1,300.0	0.0	1,300.0	0.0	1,300.0	0.0
Total	56,699.7	4.8	60,414.2	6.6	66,170.0	9.5	68,780.0	3.9	69,720.0	1.4
					[66,710.0	10.4	69,900.0	4.8	71,460.0	2.2]
Receipts										
Tax Revenues	45,090.0	9.5	51,010.0	13.1	54,240.0	6.3	56,730.0	4.6	59,930.0	5.6
Nontax Revenues	2,768.7	15.1	2,293.2	-17.2	2,280.0	-0.6	2,330.0	2.2	1,090.0	-53.2
Transfer from National Debt Consolidation Fund	1,300.0	0.0	1,300.0	0.0	0.0	-100.0	0.0	0.0	0.0	0.0
Other	1,468.7	32.8	993.2	-32.4	2,280.0	129.6	2,330.0	2.2	1,090.0	-53.2
Government Bond Issues	8,841.0	-15.8	7,111.0	-19.6	5,780.0	-18.7	5,780.0	0.0	5,780.0	0.0
Deficit Bonds	3,151.0	-36.7	1,331.0	-57.8	0.0	-100.0	0.0	0.0	0.0	0.0
Construction Bonds	5,690.0	3.1	5,780.0	1.6	5,780.0	-18.7	5,780.0	0.0	5,780.0	0.0
Total	56,699.7	4.8	60,414.2	6.6	62,300.0	3.1	64,840.0	4.1	66,800.0	3.0
Shortfall	—	--	--	--	3,870.0		3,940.0		2,920.0	
					[4,410.0		5,060.0		4,660.0]	
Current Expenditures					3,760.0		3,850.0		2,920.0	
					[4,190.0		4,750.0		4,270.0]	
Capital Expenditures					110.0		90.0		60.0	
					[220.0		310.0		390.0]	

Note: Figures in brackets allow for higher spending.

Source: Ministry of Finance

Table 8: Japan's Medium-Term Fiscal Projection, FY 1989-FY 1993

(in billions of yen and percent change)

	FY 1989		FY 1990		FY 1991		FY 1992		FY 1993	
Expenditures										
General Account	Y34,080.5	3.3%	Y35,373.1	3.8%	Y37,200.0	5.2%	Y38,200.0	2.7%	Y39,260.0	2.8%
					[37,760.0	6.7	39,350.0	4.2	41,020.0	4.2]
Current Expenditures	26,869.9	3.8	28,109.9	4.6	29,870.0	6.3	30,860.0	3.3	31,820.0	3.1
					[30,320.0	7.9	31,790.0	4.8	33,250.0	4.6]
Capital Expenditures	7,210.6	1.8	7,163.2	0.7	7,330.0	0.9	7,340.0	0.1	7,440.0	1.4
					[7,440.0	2.4	7,560.0	1.6	7,770.0	2.8]
National Debt Service	11,664.9	1.3	14,288.6	22.5	15,100.0	5.7	15,400.0	2.1	15,590.0	1.2
Transfers to Local Government	13,368.8	22.6	15,275.1	14.3	16,350.0	6.1	17,350.0	6.1	18,370.0	5.9
Industrial Investment Special Account	1,300.0	0.0	1,300.0	0.0	1,300.0	0.0	1,300.0	0.0	1,300.0	0.0
Total	60,414.2	6.6	66,236.8	9.6	69,950.0	5.6	72,260.0	3.3	74,520.0	3.1
					[70,510.0	6.5	73,410.0	4.1	76,280.0	3.9]
Receipts										
Tax Revenues	51,010.0	13.1	58,040.0	13.7	5,9,980.0	3.4	63,180.0	5.3	66,640.0	5.5
Nontax Revenues	2,293.2	-17.2	2,639.6	15.1	1,120.0	-16.4	1,180.0	5.4	1,330.0	12.7
Transfer from National Debt Consolidation Fund	1,300.0	0.0	1,300.0	0.0	0.0	-100.0	0.0	0.0	0.0	0.0
Other	993.2	-32.4	1,339.6	34.9	1,120.0	-16.4	1,180.0	5.4	1,330.0	12.7
Government Bond Issues	7,111.0	-19.6	5,593.2	-21.3	5,190.0	-7.2	4,790.0	-7.7	4,390.0	-8.4
Deficit Bonds	1,331.0	-57.8	0.0	-100.0	0.0	0.0	0.0	0.0	0.0	0.0
Construction Bonds	5,780.0	1.6	5,593.2	-3.2	5,190.0	-7.2	4,790.0	-7.7	4,390.0	-8.4
Total	60,414.2	6.6	66,236.8	9.6	66,290.0	0.1	69,150.0	4.3	72,360.0	4.6
Shortfall	—	—	—	—	3,660.0		3,110.0		2,160.0	
					[4,220.0		4,260.0		3,920.0]	

Note: Figures in brackets allow for higher spending.

Source: Ministry of Finance

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JAPAN · ECONOMIC · INSTITUTE

JEI

REPORT

A Two-Part Report: A and B

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IN THIS ISSUE:

Japan Ranked As World's Top Aid Donor 1
Trade White Paper Stresses Role Of Consumer 4
Japanese Banks Hit Bumps 5
Government Projects Long-Term Labor Shortage ... 8
Tokyo Previews Summit Agenda 9
Tokyo, Washington Hammer Out Final SII Report 11

Japan Ranked As World's Top Aid Donor

The Organization for Economic Cooperation and Development has calculated that Japan's economic assistance program now officially qualifies its ranking as the largest donor of foreign aid among the 18 nations that comprise the OECD's Development Assistance Committee. Last year net Japanese disbursements of official development assistance totaled $9 billion (see Table 1), up 4 percent allowing for changes in prices and in the yen-dollar exchange rate. Although Japan's ODA decreased 1.9 percent in dollar terms from 1988's level, in yen terms it increased 5.6 percent. Bilateral assistance rose 12 percent, but multilateral contributions were off 15 percent because of accidental timing factors.

The United States lost its longtime top ranking when its 1989 net disbursements declined 27.4 percent in real terms to under $7.7 billion, dropping it to the number-two position among DAC donors. The significant fall can be traced largely to the timing of U.S. contributions to multilateral institutions, the OECD said, noting that in 1988 Washington paid two large installments on its contribution to the International Development Association -- the soft loan window of the World Bank. Although many people in the aid community

Table 1: ODA of Major Donor Countries, 1985-89

(in millions of dollars)

1989 Rank	Country	1985	1986	1987	1988	1989*	Share of Total DAC ODA 1989*
1	Japan	$3,797	$5,634	$7,454	$9,134	$8,958	19.3%
2	United States	9,403	9,564	8,945	10,141	7,664	16.5
3	France**	3,995	5,105	6,525	6,865	7,467	16.0
4	West Germany	2,942	3,832	4,391	4,731	4,953	10.7
5	Italy	1,099	2,403	2,615	3,193	3,325	7.2
6	United Kingdom	1,530	1,737	1,871	2,645	2,588	5.6
7	Canada	1,631	1,695	1,885	2,347	2,302	5.0
DAC Total		29,429	36,653	41,535	48,132	46,498	100.0

*Preliminary.
**Including overseas territories and prefectures.

Source: Organization for Economic Cooperation and Development

Table 2: ODA as Percentage of GNP for DAC Countries, 1985-89

(in millions of dollars)

		1985		1986		1987		1988		1989*		Percent Change
1989 Rank		Amount	Percent of GNP	Amount	Percent of GNP	Amount	Percent of GNP	Amount	Percent of GNP	Amount	Percent of GNP	1988-89*
1	Norway	$574	1.01%	$798	1.20%	$890	1.09%	$985	1.10%	$919	1.02%	-6.7%
2	Denmark	440	0.80	695	0.89	859	0.88	922	0.89	1,003	1.00	8.9
3	Sweden	840	0.86	1,090	0.85	1,375	0.88	1,534	0.86	1,809	0.98	18.0
4	Netherlands	1,136	0.91	1,740	1.01	2,094	0.98	2,231	0.98	2,094	0.94	-6.2
5	France**	3,995	0.78	5,105	0.72	6,525	0.74	6,865	0.72	7,467	0.78	8.8
6	Finland	211	0.40	313	0.45	433	0.49	608	0.59	705	0.63	16.0
7	Belgium	440	0.55	549	0.49	685	0.48	618	0.41	716	0.47	15.9
8	Canada	1,631	0.49	1,695	0.48	1,885	0.47	2,347	0.50	2,302	0.44	-1.9
9	West Germany	2,942	0.47	3,832	0.43	4,391	0.39	4,731	0.39	4,953	0.41	4.7
10	Italy	1,098	0.31	2,404	0.40	2,615	0.35	3,193	0.39	3,325	0.39	4.1
11	Australia	749	0.48	752	0.47	627	0.34	1,101	0.46	1,017	0.37	-7.6
12	Japan	3,797	0.29	5,634	0.29	7,456	0.31	9,134	0.32	8,958	0.32	-1.9
13	United Kingdom	1,530	0.33	1,750	0.32	1,887	0.28	2,645	0.32	2,588	0.31	-2.1
14	Switzerland	302	0.31	422	0.30	547	0.31	617	0.32	559	0.30	-9.5
15	Austria	248	0.38	198	0.21	201	0.17	301	0.24	282	0.23	-6.4
16	New Zealand	54	0.25	75	0.30	87	0.26	104	0.27	87	0.22	-16.0
17	Ireland	39	0.24	62	0.28	51	0.19	57	0.20	49	0.17	-12.9
18	United States	9,403	0.24	9,564	0.23	8,945	0.20	10,141	0.21	7,664	0.15	-24.4
DAC Total		29,429	0.35	36,653	0.35	41,535	0.34	48,132	0.36	46,498	0.33	-3.4

*Preliminary.
**Including overseas territories and prefectures.

Source: Organization for Economic Cooperation and Development had expected Japan to take the lead in foreign assistance in 1988, this country's $1.9 billion in IDA payments helped to keep the United States at the top of the donor list.

The OECD said similar timing factors were behind the $1.6 billion decline in overall DAC net disbursements to developing countries and multilateral institutions in 1989. The drop from the 1988 level of $48.1 billion to $46.5 billion represented a decrease of 2 percent in real terms. Foreign aid as a percentage of gross national product for DAC members combined also fell last year, dropping from 0.36 percent in 1988 to 0.33 percent (see Table 2). Norway, Denmark, Sweden and the Netherlands boasted the highest ODA/GNP ratios, all hovering around 1 percent. Japan's ratio did not budge from the 1988 figure of 0.32 percent, ranking it 12th among DAC members. The United States gave the smallest share of GNP, 0.15 percent in 1989 compared to 0.21 percent the year before.

Tokyo has taken significant steps to strengthen its foreign aid program in line with its efforts to assume more international responsibility as befitting its economic power. In the fourth medium-term foreign aid program announced in June 1988 Tokyo outlined plans to improve both the quality and the quantity of its assistance. One goal is to move Japan's ODA/GNP ratio closer to the DAC average by the end of 1992 by doubling the aggregrate volume of foreign aid disbursed between 1988 and 1992. (Of course, Japan's efforts to meet this goal may be facilitated if the DAC average continues to drop.) Japan plans to spend $50 billion on foreign aid over this five-year period. The OECD predicted that, given these goals, continued increases in Japanese aid disbursements can be expected.

Although the Ministry of Foreign Affairs greeted the June 25 release of the latest DAC figures by cautioning that changes in exchange rates may make it difficult for Japan to fulfill its five-year aid plan, officials also expressed willingness to further increase foreign aid. The general account budget for the year starting April 1, 1990 contained another in a series of substantial annual increases for foreign economic assistance. The FY 1990 budget for foreign aid was raised 7.8 percent, the largest percentage increase of any discretionary budget category (see JEI Report No. 26A, July 6, 1990).

Although timing considerations certainly exaggerated the drop in DAC members' 1989 net disbursement levels, many foreign aid programs have faced serious challenges brought on by budget constraints and the demands of a dramatically different global political environment. The gradual drop in the U.S. ODA/GNP ratio over the past five years reflects Washington's own struggle to formulate a foreign aid budget under such pressures. The $15.6 billion foreign assistance appropriations bill passed by the House June 27 contains an increase of $112 million over the fiscal 1990 appropriation as well as some shifting of resources from security-related programs to economic development assistance. Yet political and financial constraints have preempted major changes in U.S. foreign assistance priorities and funding levels, and many American policymakers are calling for a major overhaul of the program. As Japan faces the demands of its new role as the world's leading foreign aid donor, the United States is likely to continue to face its own foreign aid challenges.

Margo Grimm

Trade White Paper Stresses Role Of Consumer

The Ministry of International Trade and Industry's annual trade white paper typically is a mix of something old, something new and something borrowed. The latest report, released June 22, is no exception. Something old was MITI's concern over the rising threat of protectionism, particularly in the United States. MITI stressed the important role that free trade plays as an international public good -- which implies that each participant can benefit without harm to other parties. In this vein the ministry emphasized the role Tokyo has in maintaining the present free trading system and, concurrently, the importance of the successful conclusion of the Uruguay Round of multilateral trade negotiations. With respect to Japan's trade surplus with the United States the ministry noted that the imbalance is not exclusively the result of Japanese barriers, and it suggested a number of policies that Washington should take to reduce the imbalance. These measures -- headed by reduction of the federal budget deficit -- largely repeat Tokyo's list of policy prescriptions for the United States laid out in the recently concluded Structural Impediments Initiative talks (see article in this issue).

This year's new concerns center on East-West relations. MITI acknowledged the severe economic problems confronting the Soviet Union and Eastern Europe and called for increased Western help for that region. However, it also called for internal reforms that would help improve the trade atmosphere for Western companies faced with such problems as the lack of currency convertibility, well-defined accounting procedures, antitrust laws and other components of a market-oriented economic system.

Something borrowed concerned its stress on improving the lot of the Japanese consumer, a cause championed by Washington in the SII talks. MITI emphasized the importance of eliminating price discrepancies between Japan and the rest of the world and reforming the distribution system to make the benefits of open markets more available to consumers. MITI's analysis found that in most respects Japanese living standards today are lower than those of the United States or West Germany 20 years ago.

MITI also noted other changes in the pattern of international trade. It argued that products with standardized measures of quality are being replaced by goods in which hard-to-measure attributes, such as design, are more important. American critics have noted that Japan imports far fewer such differentiated products, which generally account for much of what is called intra-industry trade, than do most other industrialized countries. Low intra-industry trade, other factors equal, implies low levels of manufactured imports. While acknowledging this difference between Japan and its competitors, MITI pointed out in apparent response that imports of manufactured goods accounted for over 50 percent of Japan's total imports in 1989 for the first time and that the share of imports in the consumer market had increased significantly between 1985 and 1989.

In short MITI found the Japanese trade structure generally heading in exactly the direction that would appear to meet American concerns. In areas where such movement is not as obvious, MITI called for new policies to induce such a redirection. American critics are likely to buy at least some of the arguments concerning the direction of change, but they may dispute MITI's contention that movement is rapid. While the ministry generally paints a picture of the Japanese economy converging with the trade patterns of other industrial nations, U.S. analysts are sure to point to the many dimensions of globalization in which the Japanese economy continues to lag these countries by a substantial margin. These same critics are likely to note that the yen's dramatic appreciation between 1985 and late 1988 and Japan's accelerated economic growth since 1987 have been at least partly responsible for the realignment in the direction that MITI described. For these reasons many American analysts suggest that the jury is still out as to whether similar realignments will continue in the face of the relative currency stability and the slower economic growth that could characterize the early 1990s.

Douglas Ostrom

Japanese Banks Hit Bumps

A year ago Japanese banks looked invincible: they were enjoying a fourth year of record profits; their issues of new equity were greeted with open arms at home and abroad; the value of their stock portfolios was skyrocketing; and their international presence was expanding rapidly. Although Japanese banks still dominate world rankings in terms of total assets and deposits, business results for FY 1989 were mixed, dissipating their aura of invulnerability. The data highlight several weaknesses that will challenge management in coming years.

Operating revenues boomed for all major Japanese banks in FY 1989, according to figures compiled by the Japan Economic Journal (see Table). For the 13 nationwide commercial banks combined operating revenues in FY 1989 were Y31,148.7 billion ($207.7 billion at Y150=$1.00), a 38.8 percent gain over the Y22,466.5 billion ($149.8 billion) recorded the year before. The three long-term credit banks' operating revenues grew 28.8 percent from Y4,649.9 billion ($31 billion) to Y5,988.5 billion ($39.9 billion), while those for the seven largest trust banks increased 33.2 percent to Y6,609.8 billion ($44.1 billion) from Y4,962.6 billion ($33.1 billion).

Conversely, net profits were down across-the-board. Total net profits for the 13 commercial banks fell from Y1,247.6 billion ($8.3 billion) to Y1,102.5 billion ($7.4 billion). The seven trust banks recorded an identical 11.6 percent decline in net profits, which dropped from Y323.7 billion ($2.2 billion) to Y286.3 billion ($1.9 billion). The long-term credit banks faired a bit better; their net profits fell 9.9 percent to Y182.2 billion ($1.2 billion).

A complex maze of factors led to the decline in net profits despite greater operating revenues. While profits from domestic bond dealings dropped sharply as the market withered in the face of higher interest rates, booming profits from foreign exchange trading more than made up (in most cases) for the losses. Overseas operations also contributed more in FY 1989 than the year before, sometimes significantly more. Saitama Bank, Ltd., for example, enjoyed a near tripling of profits from overseas business, from Y5.7 billion ($38 million) to Y16.2 billion ($108 million). Sumitomo Bank, Ltd. led the commercial banks in this area, earning Y165.2 billion ($1.1 billion) abroad; its FY 1988 overseas profits were Y116.3 billion ($775.3 million).

Business Results of Selected Major Japanese Banks

(in billions of yen)

	Operating Revenues	Net Profits	Total Assets	Latent Stock Profits	Market Rate Funds*	Nonper-forming Loans	BIS Capital Ratio
Sumitomo Bank, Ltd.							
FY 1989	Y4,151.1	Y174.5	Y62,773.4	Y2,887.7	63.0%	Y300.9	8.44%
FY 1988	2,934.6	198.3	52,962.1	3,466.6	52.0	379.5	8.29
Dai-Ichi Kangyo Bank, Ltd.							
FY 1989	4,083.4	155.5	66,590.8	3,537.1	58.0	261.8	8.30
FY 1988	2,987.0	179.7	54,280.6	4,339.0	47.0	338.8	8.22
Mitsubishi Bank, Ltd.							
FY 1989	3,663.7	149.8	60,673.2	3,463.1	67.0	260.3	8.40
FY 1988	2,618.9	167.3	49,619.7	4,049.9	51.0	338.8	8.36
Mitsui Bank, Ltd.							
FY 1989	2,040.5	64.9	34,634.3	2,353.7	65.0	160.8	6.90
FY 1988	1,543.2	79.4	29,040.1	2,840.9	54.0	193.5	7.32
Taiyo Kobe Bank, Ltd.							
FY 1989	1,636.5	50.8	28,712.3	2,042.2	59.0	105.0	7.20
FY 1988	1,204.0	53.5	24,134.1	2,223.3	42.0	164.3	7.50
Daiwa Bank, Ltd.							
FY 1989	1,195.1	33.0	18,770.8	1,629.0	62.0	64.6	8.40
FY 1988	831.0	39.0	15,382.3	1,616.3	41.0	92.9	8.60
Bank of Tokyo, Ltd.							
FY 1989	2,137.3	50.9	31,816.3	1,226.6	38.0	573.8	8.00
FY 1988	1,443.7	59.2	26,106.4	1,671.2	31.0	663.1	8.00
Industrial Bank of Japan, Ltd.							
FY 1989	2,747.4	83.3	43,602.7	4,120.0	21.0	191.1	7.80
FY 1988	2,158.8	93.5	37,449.4	5,148.0	19.0	261.5	9.00
Long-Term Credit Bank, Ltd.							
FY 1989	1,979.9	64.0	30,339.2	2,990.0	15.0	251.4	8.20
FY 1988	1,520.7	70.7	24,849.7	3,779.6	15.0	286.7	7.10
Sumitomo Trust & Banking Co., Ltd.							
FY 1989	1,527.0	62.2	18,858.8	1,638.2	33.0	99.6	11.10
FY 1988	1,086.1	73.5	16,593.9	1,991.6	26.9	116.5	12.30
Mitsubishi Trust & Banking Corp.							
FY 1989	1,476.0	68.3	21,500.6	1,766.6	35.0	101.9	11.10
FY 1988	1,107.8	77.5	17,204.0	2,223.1	27.9	131.1	12.80
Mitsui Trust & Banking Co., Ltd.							
FY 1989	1,167.8	54.0	16,051.7	1,920.0	34.6	123.7	10.24
FY 1988	906.2	60.5	12,774.2	2,375.5	24.8	142.4	9.23

*Percentage of total funds raised through instruments bearing market-determined rates.

Source: Japan Economic Journal

Although the profit picture was mixed, costs rose unambiguously. Four discount rate hikes by the Bank of Japan between May 31, 1989 and March 20, 1990 ratcheted up the average cost of raising funds. In addition, the Ministry of Finance's deregulation program forced banks to offer market rates of return to attract deposits. The 13 nationwide commercial banks relied on market-rate instruments to raise 58.5 percent of all funds in FY 1989, up sharply from the 45.5 percent level the previous year. Both trust banks (36.5 percent versus 28 percent) and long-term credit banks (20.7 percent from 19.2 percent) also were forced to shift in this way.

Most major Japanese banks made major charges against profits in FY 1989 to raise reserves for nonperforming loans to the Third World. The total amount of "doubtful credit" fell 20.9 percent for the covered commercial banks (from Y3,407.4 billion or $22.7 billion to Y2,695.5 billion or $18 billion), 19.6 percent for the long-term credit banks (to Y579.5 billion or $3.9 billion) and 15.8 percent for the trust banks (to Y548.7 billion or $3.7 billion). Write-offs associated with the Mexican debt deal (see JEI Report No. 6B, February 9, 1990), for example, cost the national commercial banks an estimated Y590 billion ($3.9 billion) and long-term credit banks an additional Y89 billion ($593.3 million). Japanese banks are expected to raise their loan loss reserves for Third World debt from the current 25 percent range to 30 or 35 percent this year and to the 45 percent level of American and European banks over the next few years. Each additional 5 percentage points of reserves takes an estimated Y150 billion ($1 billion) out of the profits of commercial and long-term credit banks.

The assets of all major banks were up strongly in FY 1989, reflecting solid economic activity at home and abroad. While the assets of the 13 big commercial banks continued to dwarf those of the other two groups -- rising 20.7 percent to Y508.3 trillion ($3.4 trillion) -- the total assets of trust banks showed a greater percentage gain, 23.7 percent to Y70.9 trillion ($472.7 billion). Long-term credit banks had a combined asset gain of 17.6 percent, bringing their total to just over Y92.5 trillion ($616.7 billion).

One factor powering asset growth in previous years was the spiraling value of issues on the Tokyo Stock Exchange, which inflated the latent profits of banks' stock portfolios. (Latent profits equal the difference between book and current market values.) This inflation ended in FY 1989 as the TSE fell back during the last quarter of the fiscal year. Latent stock profits for the listed commercial banks were off a combined 13.8 percent, those for trust banks were down 16.8 percent and long-term credit banks showed a 20.6 percent decline.

Weaker net earnings, reduced latent profits and strong asset growth spell trouble for Japanese banks' efforts to raise their equity/asset ratios as required by the Bank for International Settlements (see JEI Report No. 25B, July 1, 1988). Although the 13 nationwide commercial banks were able to raise their average capital adequacy ratio in FY 1989 to 8.12 percent from 7.97 percent, five in the group posted declines (Fuji Bank, Ltd., Mitsui Bank, Ltd., Taiyo Kobe Bank, Ltd., Daiwa Bank Ltd. and Saitama Bank). Trust banks also managed to raise their average ratio -- from 10.4 percent to 11.03 percent -- even though three of the seven showed declines. By a statistical coincidence the average ratio for trust banks did not change between FY 1988 and FY 1989 despite a major drop by Industrial Bank of Japan, Ltd. Despite the mixed picture, most banks have achieved the required 8 percent overall ratio. It is not clear, however, how the banks stand in regard to the 4 percent requirement for "core" capital.

While the data show that Japanese banks remain sound and strong international competitors, weak spots also are revealed. It is clear that managers have chosen not to restrain asset growth as they strive to meet the BIS capital requirements. But poor net profits plus the potential for further declines in the value of bank stock portfolios and the likelihood of significant additions to loan loss reserves cast strong doubts on the banks' plans to boost profits and net equity. Japanese banks have two more years to solidify their balance sheets in preparation for the 1992 deadline set for implementation of the BIS guidelines.

Jon Choy

Government Projects Long-Term Labor Shortage

Although Japan's second-longest economic expansion has profited many corporations, a painful side effect, particularly for small and medium-sized companies, has been a chronic labor shortage. The unemployment rate ebbed from 2.4 percent in FY 1988 to 2.2 percent in the year ending March 31, 1990; in the January-April period of this year unemployment averaged just 2.1 percent. The effective job opening ratio, another indicator of supply and demand in the labor market, has been at or above 1.3 openings for every applicant since May 1989; in May this year it reached 1.41.

These indicators support the argument that Japan's labor market needs new sources of workers from the underutilized populations represented by women, senior citizen and foreigners. The Ministry of Labor suggested in May that no relief from a tight labor market can be expected either in the near term or into the next century provided that current forecasts of continued solid economic expansion (see JEI Report No. 25B, June 29, 1990) prove true and that any long-term slowdown is only gradual.

MOL bases its long-term projection of a labor shortage on a decline in the expansion of real gross national product from a projected 4 percent in FY 1990 to an estimated 3.2 percent in FY 2000 and a forecast 2.6 percent in FY 2010. As reported in the June 19 edition of Nihon Keizai Shimbun, MOL determined the future demand for labor by multiplying the expected rate of economic growth by the elasticity of demand for labor, which was placed at 0.25, the average 1980-90 figure. The results were an estimated 66.3 million workers required in 1995, 69 million in 2000, 71.3 million in 2005 and 73.7 million in 2010.

But the supply of labor was projected to grow at an average annual rate of only 0.7 percent until 1995 and then shrink after 2000, a reflection mainly of demographic changes in which the population of men aged 15 to 64 is expected to decline. MOL further calculated that cutting the number of hours worked, a current government goal (see JEI Report No. 23B, June 15, 1990), also would decrease the labor supply; that effect, the ministry said, could be offset by a continuing rise in productivity obtained, for example, by increasing wages. Based on these estimates, MOL forecast that the labor supply will be 65.8

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MONETARY POLICY IN JAPAN

Summary

Price stability amid Japan's continuing economic growth during the 1980s has been remarkable. The low rate of inflation calls attention to the handling of monetary policy. Since the 1970s the Bank of Japan, which has primary authority over monetary matters, continuously has adjusted the way in which it conducts policy but consistently has placed great importance on price stability. At times, ongoing changes in Japan's domestic and international financial structure have complicated monetary policy. While the goals differ only slightly, monetary policy as practiced in Japan differs in significant respects from monetary policy in the United States and other industrialized countries. Some analysts see signs that BOJ would like both its practices and its independence to conform more closely to that of the Federal Reserve Board, its American counterpart.

What Is Monetary Policy?

Monetary policy basically involves money. At least as long as governments have maintained a means of payment for goods and services, they necessarily have had a policy toward controlling that means of payment. Thus, they have had a monetary policy. That policy must take account of four dimensions of the supply and the demand for money: its amount, its intensity of use, the quantity of goods and services for which it serves as a means of payment and the price level of these goods and services.

Money can be thought of as the means by which the production and the consumption of goods and services are financed. If money has high velocity (is used intensively), then less is needed to finance any given level of transactions for goods and services at a given level of prices. Similarly, if more goods and services are produced and purchased, then change occurred in one or more of the other three variables: the amount of money increased, its velocity rose or prices dropped. (More formally, this relationship can be expressed by the following equation: money times velocity equals prices times output.)

The Controversy Over Monetary Policy

Monetary policy has to do with a government's direct or indirect control of one of these four elements -- the amount of money -- and how that affects or is affected by the other three. Unfortunately, the causal relationships are murky at best. For example, some experts believe that an increase in the money supply leads almost directly in many situations to an increase in the level of prices because they do not believe changes in the money supply significantly affect velocity or output. According to this school, monetary policy has little positive purpose in solving unemployment problems.[1] This suggests that the government should alter the supply of money only with great reluctance since the risk of inflation is great and the potential payoff in terms of increased output minimal. Most economists would agree that when output already is high, money expansion is unusually risky. Even when this rare consensus among economists has been present, Japanese prime ministers, American presidents or Latin American dictators have not necessarily accepted the economists' advice.

Other experts suggest that the causation runs at least partly in the other direction -- that increased transactions in goods and services call forth more money. Still others believe that velocity is highly capricious, leading to unstable relationships among the other three variables. Complicating most of these theories still further is the now widepread belief that past monetary policy influences the effectiveness of future policies. For example, a country that has enjoyed many years of price stability could be expected to react differently to an expansionary monetary policy than one with a history of inflation. In the first instance consumers might believe that the increased funds in their hands represent a real gain and respond accordingly. In the latter case they would run for cover (get rid of money) to protect themselves against the expected price increases; such a response would boost velocity and virtually guarantee the feared inflation.

Exchange rates necessarily are a dimension of monetary policy. Under a system where currency values float freely, a drop in interest rates (a monetary expansion), for example, has several important effects. To the extent that the larger money supply leads to higher rates of inflation, the value of the

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[1] Some experts believe that this view is at least implicit in theories of real business cycles, for example. See N. Gregory Mankiw, "Real Business Cycles: A New Keynesian Perspective," The Journal of Economic Perspectives, Summer 1989, p. 81. For an opposing view, see Charles I. Posser, "Understanding Real Business Cycles," The Journal of Economic Perspectives, Summer 1989, p. 70.

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currency will fall in international markets to offset the reduced competitiveness of exports and domestic substitutes for imports. Even without inflation the boost in aggregate demand that results from lower interest rates can be expected to increase the demand for imports, leading to a lower exchange rate to maintain exports. In addition, lower domestic interest rates will make financial instruments at home relatively less attractive compared to options overseas; this leads to a capital outflow, a demand for foreign exchange and a further drop in the local currency. Finally, changes in the exchange rate could feed back on price levels. For example, should the domestic currency depreciate, import prices will rise, other factors equal. This could complicate the objective of price stability.

Japanese Monetary Policy: Traditional Practices

During and immediately after World War II Japan had a monetary experience that leaves scars even today. While good data are scarce, some gross national product statistics indicate the extent of the disaster. Based on Japan's GNP deflator -- a broad measure of inflation -- prices were 127 times higher in 1950 than in 1940. Over the same period GNP dropped in real terms. In addition, nominal financial assets rose only one-sixth as fast as prices, suggesting an enormous drop in purchasing power for those holding financial assets.[2] In short, rapid inflation was associated with a period of economic decline and the failure of money as a store of value, one of its principal functions. No monetary policy could have prevented the economic hardship that resulted from World War II and its aftermath. However, the memory of the hyperinflation of that period undoubtedly served to heighten inflationary fears in subsequent years.

In the early postwar years those fears were offset by the perceived need for economic recovery and expansion. From the 1950s to the early 1970s the Bank of Japan pursued a monetary policy that accommodated extremely rapid rates of growth while producing relatively low rates of inflation, although prices rose more rapidly than in the United States during this period. Consumer prices increased 5 to 6 percent annually from the early 1960s to the early 1970s, while real GNP often grew at double-digit rates. In accomplishing these objectives BOJ used policy instruments that were unusual by the standards of the Federal Reserve Board and the central banks of most other industrial countries. In many respects these tools continue in use to this day, although not to the extent that some analysts claim.

Then and now BOJ possessed, in principle, the same policy tools as the Fed has in this country.[3] For example, it could change bank reserve requirements. By reducing reserve requirements, BOJ could hope for a multiplier effect as banks lent out a higher proportion of funds on deposit and, thus, helped create a larger money supply. This is a blunt instrument that neither the Fed nor BOJ has used often. The Fed long has preferred another option also available to BOJ: open-market operations. In such cases the central bank can create liquidity in the banking system by buying securities from the banks or the public, thereby typically leading to an increase in money in the banking system and throughout the economy. This process also can operate in reverse. Selling securities to banks drains liquidity and is likely to lead to a monetary contraction.

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[2] Cited in Serguey Braguinsky, "A Criticism of Monetarism -- With Some Points from the Japanese Experience," Keio Economic Studies, 25(2), 1988, p. 43.

[3] For a detailed description of BOJ policy instruments, see Yoshio Suzuki, The Japanese Financial System (Oxford, England: Clarendon Press, 1987), pp. 317-326.

The open-market option works best if securities markets are well developed, which certainly was not the case in early postwar Japan. Instead of open-market operations BOJ reached for a third alternative that the Fed uses relatively little: lending to financial institutions. As with open-market operations the central bank can create liquidity in the banking system by such lending. This option led to the phenomenon of "overloans." Banks were able to lend out more money than they had on deposit because of their ability to borrow money from the Bank of Japan on favorable terms.

Overloans led to another characteristic feature of the period: "window guidance." If BOJ felt the expansion of credit was excessive, it would exert pressure on the banks in the form of administrative guidance to curtail lending. Strictly speaking, adherence to such guidelines was voluntary, but BOJ's lending on favorable terms to the same institutions certainly gave it considerable leverage.

With such a critical role played by BOJ's lending mechanism, the discount rate (the cost of such funds) had a high profile. The bank changed the rate infrequently, giving each change all the more significance. It obviously was -- and still is -- an important signal of the direction of BOJ policy; higher rates indicate a tighter monetary policy, lower rates the reverse. Even banks that were not borrowing from BOJ paid close attention to the discount rate to determine which way the monetary wind was blowing. In addition, the discount rate directly or indirectly is linked to a number of other critical interest rates. After a discount rate change a consultative process led to the adjustment of other administratively determined rates.

Recent Monetary Policy

The early 1970s ushered in an era of rapid change. The first important development for BOJ came with the breakdown of the Bretton Woods regime of fixed exchange rates in 1971. The bank bought up large amounts of foreign currency in an effort to save the system, but this action created excess liquidity in the economy and brought down market interest rates independently of BOJ-posted rates.[4] Of course, once flexible exchange rates became the norm, BOJ gained increased flexibility, at least on paper. Money could be tightened or loosened without necessarily having to defend the exchange rate at the same time.

The 1973-74 oil crisis created further inflationary pressures that the existing system was poorly equipped to handle. As the surge in oil prices worked its way through the economy Japan experienced its worst inflation since the immediate postwar period. From 1955 to 1970 consumer prices rose a cumulative 88.3 percent, using 1975 weights. In just the next five years they jumped 72.4 percent on the same basis.

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[4] This example is drawn from Robert Alan Feldman, Japanese Financial Markets (Cambridge, Massachusetts: MIT Press, 1986), pp. 118-119.

Other changes were occurring independently of the Bretton Woods collapse and the run-up in oil prices. Corporations had less need to borrow from banks, which, in turn, became less dependent on BOJ lending. In addition, the government began running large budget deficits that required financing. Absorbing these government bonds created new challenges for the financial system. Finally, as financial markets became more internationalized -- a process that accelerated in the early 1980s -- banks acquired more options to act independently of BOJ.

These changes suggested that the system of administratively determined interest rates could not continue unaltered. By necessity an increasing number of rates floated in response to market conditions. Others, while nominally market-determined, in fact seemed to continue to take their cue from the posted rates. As more and more rates were freed, adjustments of the remaining rates became increasingly frequent. The unconditional call rate, for example, was changed only eight times in 1976 and 20 times in 1977, but by the early 1980s it was being altered as often as 200 times a year.[5]

In any case, as posted interest rates and direct BOJ lending lost some of their efficacy as policy tools, new procedures arose to take their place. In June 1972 BOJ began open-market operations using commercial bills. In May 1981 it began selling short-term government securities on the open secondary market to absorb excess liquidity, albeit in small amounts. In 1985 the bank also began buying government securities in periods of deficient liquidity. In March 1986 it began open-market operations in certificates of deposit. As of 1986 Robert Alan Feldman, then an economist at the International Monetary Fund, concluded that the new tools and the old ones coexisted.[6]

Financial liberalization continued through the 1980s. (For details of recent financial liberalization measures, see JEI Reports No. 20A, May 18, 1990 and No. 27B, July 13, 1990.) Among those moves closely related to the implementation of monetary policy have been several within the past two years.

- In November 1988 BOJ made a major change in the way in which it conducts open-market operations. It shortened the minimum maturity of commercial discount bills -- one of its principal intervention instruments -- to one to two weeks, prior to that the shortest maturity had been one to three months. By using such a fast-maturing instrument, BOJ felt it could better exert its will. Extremely short-term rates depend almost entirely on the level of bank reserves, over which BOJ can exert direct influence by its lending, open-market operations and other policy instruments. By contrast, even one- to three-month bills are affected by investors' expectations of inflation and expected, as opposed to actual, BOJ policy. In moving toward a shorter-term instrument, BOJ also was conforming more closely to Fed practice.

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[5] Thomas F. Cargill and Shoichi Royama, The Transition of Finance in Japan and the United States (Stanford, California: Hoover Institution Press, 1988), p. 77.

[6] Feldman, op. cit., p. 120.

- In May 1989 BOJ began buying commercial paper as an open-market operation. At the time commercial paper was quite new in Japan, having been introduced in November 1987 (see JEI Report No. 44B, November 20, 1987).

- In December 1989 BOJ began lending to foreign banks with offices in Japan. Since such loans may be attractively priced, foreign banks presumably welcomed the move, which nonetheless does potentially subject them to window guidance. The Ministry of Finance reportedly may even permit foreign brokers as well as other new participants into the short-term money market, which remains a critical part of the transmission process for BOJ policy. If that should happen, foreign institutions would in effect become lieutenants in future BOJ monetary initiatives. BOJ reportedly has raised objections to having more participants in this process.

- In January this year BOJ began using treasury bills in market operations. However, the T-bill market is small. Late last year outstanding treasury bills amounted to Y4 trillion ($26.7 billion at Y150=$1.00), a small fraction of the short-term money market; outstanding call loans and bills in early 1990 totaled Y40 trillion ($266.7 billion). The T-bill market reportedly will rise to an average level of Y7.5 trillion ($50 billion) in FY 1990 and to Y10 trillion ($66.7 billion) in FY 1991. If BOJ were to use financing bills, another type of short-term government security that so far totals about Y20 trillion ($133.3 billion), its market operations using government securities could increase significantly. However, financing bills are not issued at market interest rates, limiting their usefulness.

Press reports suggest that MOF and BOJ are contemplating still more kinds of market operations, including an option that would involve consolidated bills backed by government securities. No timetable has been suggested for this innovation, however.

Taken together these recent moves show a definite pattern: BOJ is expanding open-market operations at the expense of direct lending to banks. As such, these measures suggest a continuation of a process that began in the 1970s of moving closer to the Fed style. Other indications point to a larger role for foreign banks in the implementation of monetary policy in Japan. At the same time, though, the liberalization process is far from complete. Window guidance remains in force. For example, BOJ, concerned about inflationary pressures, reportedly is pressing banks to restrain their lending significantly in the July-September 1990 period. In addition, the use of short-term government securities for open-market operations, a fixture of monetary policy elsewhere, remains severely limited.

Monetary Policy in Action

Assuming that a central bank believes monetary policy can play a useful role, it has a further choice to make: what means should it use to influence the economy? Central banks generally have chosen one of two possible targets: interest rates or the money supply. If the central bank decides to try to change interest rates the idea is to influence intermediate variables, such as the money supply, that affect the level of aggregate demand and output. Alternatively, the central bank can choose a money supply target directly.

Using the second operating rule, a central bank will take actions to drain reserves from the banking system if it wants to tighten money, stopping when it believes the money supply has reached the target level. The effect might well be the same as moving to raise interest rates. Some experts have advocated the money supply approach since an interest rate target may not adequately reflect expected inflation. If the central bank selects a higher nominal rate, it inadvertently may be accommodating a lower real rate if firms expect inflation to pick up. One problem with a money supply operating rule is picking the correct measure among several different money supply concepts.

The evidence suggests that BOJ uniformly selects the interest rate operating rule and focuses on interbank rates, such as the call rate and the commercial bill rate. In this context a change in the discount rate sends a clear signal about desired market rates. The more recent practice of open-market operations involving commercial bills or other instruments in support of interest rates sends a similar message. In selecting an interest rate operating rule, BOJ is substantially in accord with recent Fed practice, according to Michael Dotsey of the Federal Reserve Bank of Richmond.[7]

Experience since 1987 shows the apparent wisdom of BOJ's approach. Money supply growth in Japan has been rapid by most measures (see Table 1). The most widely used measure of monetary growth, M2+CDs, which is more than four times as large as narrowly defined M1, has grown in recent years at annual rates close to or in double digits. Despite this fact, price increases have been small, and sometimes even negative, on an annual basis. For example, between 1985 and 1989 the GNP price deflator, a broad measure of inflation, varied from -0.3 percent in 1987 to 1.8 percent in 1986. These results suggest that a strict monetary operating rule, which almost certainly would have set targets far below the observed growth of M2+CDs, probably would have been too restrictive.

After peaking in 1980 interest rates began a steady decline that lasted through 1987. They began creeping up again in 1988, with sharp rises toward the end of 1989 and into the early months of 1990 (see Tables 2 and 3). Long-term rates appear to have lagged short-term rates during periods of both declines and increases. In part, this pattern may have reflected a slowly growing perception of lower inflation rates after the early 1980s. In other words, buyers of long-term securities initially demanded compensation for inflation based on Japan's experience during the two oil crises of the 1970s when prices jumped. But as expectations of inflation diminished steadily between 1980 and 1989, the required offset shrunk, too.

Since 1985 new factors have appeared that have not yet completely played out. In line with international agreements concerning currency realignment Japan began to reflate its economy in 1986. The discount rate was cut four times that year and again in early 1987, and the money supply expansion was accelerated. These moves complemented efforts starting in late 1985 to boost the value of the yen, which reduced overseas demand for Japanese exports below what it otherwise would have been. In other words, monetary policy was assigned the task of picking up the slack that presumably would have existed in the economy given the impact of the higher yen on exports. The lower interest rates were designed to stimulate domestic demand and thus lift the economy and reinforce the boost to imports that the stronger yen was to give.

[7] Michael Dotsey, "Japanese Monetary Policy: A Comparative Analysis," Economic Review, November/December 1986, p. 19.

Table 1: Changes in Money Supply and Prices in Japan, 1980-90

(percent change from year-earlier period)

	M1	M2+CDs	Wholesale Prices	Consumer Prices
1980	2.6%	9.2%	17.8%	7.7%
1981	3.3	8.9	1.4	4.9
1982	5.8	9.2	1.8	2.8
1983	3.6	7.4	-2.2	1.9
1984	2.8	7.8	-0.3	2.3
1985	5.0	8.4	-1.1	2.0
1986	6.9	8.7	-9.1	0.6
1987	10.5	10.4	-3.7	0.1
1988	8.4	11.2	-1.0	0.7
1989	4.1	9.9	2.5	2.3
1990				
January	0.5	11.5	3.7	3.0
February	0.7	11.8	3.5	3.6
March	0.8	11.6	3.9	3.5
April	0.4	13.2	2.7	2.5
May	-0.6	13.2	1.7	2.7

Notes: M1 equals currency in circulation plus "deposit money" (yokin tsuka, a concept roughly comparable to demand deposits).

M2+CDs equals M1 + quasimoney (public and private deposits at surveyed financial institutions excluding demand deposits) + certificates of deposit at surveyed financial institutions.

Sources: Bank of Japan and Management and Coordination Agency

Rapid monetary expansion, as explained earlier, necessarily is reflected in some combination of increased output, higher inflation and/or changed velocity. Obviously, BOJ officials hoped that output would be the most affected by these moves; the situation suggested this was likely. The yen's appreciation created an incipient deficiency of aggregate demand that monetary policy could help reverse. In addition, by the late 1980s Japan had a long record of price stability, suggesting that the hyperinflation of the 1940s and the double-digit inflation of the early 1970s were fading memories. In practical terms this meant that Japanese consumers and firms would not develop an inflation psychology. As a result, they would not try to get rid of their money quickly and thereby boost velocity, which would have contributed to a self-fulfilling prophecy concerning inflation.

In many ways these expectations have proved true. Gross national product eked out a mere 2.5 percent inflation-adjusted gain in 1986, in part a measure of the initial impact of the yen's appreciation. However, as the new, looser

Table 2: Representative Interest Rates in Japan, 1980-90

	Two-Month Bill Rates	Collateral Call Rates	10-Year Government Bond Yields
1980	10.0%	10.9%	8.8%
1981	7.9	7.4	8.1
1982	7.0	6.9	7.6
1983	6.6	6.4	7.4
1984	6.3	6.1	6.5
1985	6.6	6.5	5.9
1986	5.0	4.8	5.2
1987	3.9	3.5	5.1
1988	4.1	3.6	4.7
1989	5.3	4.9	5.7
1990			
January	6.8	6.4	6.6
February	7.0	6.5	6.9
March	7.4	6.6	6.9
April	7.3	7.0	6.9

Source: Bank of Japan

monetary policy increasingly took hold, real GNP increased 4.6 percent in 1987, 5.7 percent in 1988 and 4.9 percent in 1989 despite a continuing drag from net exports and, in 1989, a BOJ policy shift. As such, real GNP growth represented a sharp upturn from the 1980-85 period when it had averaged 3.9 percent a year. In addition, as noted in Table 1, prices showed remarkable stability. Velocity, rather than rising, showed a sharp decline between 1987 and 1989.

The increase in output, however, did not account for all the growth in the money supply. While the prices of goods and services failed to explode, a number of other prices did. For example, between 1985 and 1989 the Nikkei average of 225 stocks listed on the Tokyo Stock Exchange rose from Y12,556 to Y34,043. Similarly, land prices climbed; the cost of land in Japan's six largest cities jumped 84 percent between 1985 and 1988 and continued rising in 1989. (For details of 1989 land price increases using a different data series, see JEI Report No. 14B, April 6, 1990.) The result was just the reverse of what had happened in the aftermath of World War II; financial and other assets rose sharply compared to nominal GNP. The phenomenon is referred to as "asset inflation."

Asset inflation explains in part why velocity, a measure of money relative to nominal GNP, declined. Some of the increased money supply was diverted into the trading of assets. Put differently, money was less intensively used for goods and services because its role as a means of trading assets became more important. Had the rapid increase in money flowed into goods and services rather than assets, the prices of goods and services would have risen far more than they did.

Asset inflation had another dimension. Low interest rates -- the counterpart of the higher money supply -- made stocks and land attractive. To the

Table 3: Discount Rate in Japan, 1979-90

Effective Date	Rate
November 2, 1979	6.25%
February 19, 1980	7.25
March 19, 1980	9.00
August 20, 1980	8.25
November 6, 1980	7.25
March 18, 1981	6.25
December 11, 1981	5.50
October 22, 1983	5.00
January 30, 1986	4.50
March 10, 1986	4.00
April 21, 1986	3.50
November 1, 1986	3.00
February 23, 1987	2.50
May 31, 1989	3.25
October 11, 1989	3.75
December 25, 1989	4.25
March 20, 1990	5.25

Source: Bank of Japan

extent that money was used for stock and land transactions, investors had reason to hold more money as asset prices rose. In short, rises in the broadly defined money supply and other asset demand were mutually reinforcing.

Changing expectations of price increases had a similar effect. The shrinking inflation of the mid-1980s reduced the risk that people with certificates of deposit, for example, would experience a decline in the real value of their instruments. As a result, the demand to hold these instruments increased and the velocity of the money supply fell.

As long as M2+CDs and asset prices influenced mainly each other and were accompanied by falling velocity, the phenomenon could be regarded as a tempest in a financial teapot. In 1989, however, BOJ increasingly became concerned that the situation could change. To the extent that the monetary expansion flowed into demand for goods and services, BOJ no longer could count on higher output rather than price increases. Capacity utilization was rising and labor shortages, as measured by the openings-to-applicants ratio, loomed (see JEI Report No. 26B, July 6, 1990). In addition, the bank's measures of potential price inflation showed sharp jumps in 1988 and 1989. As a result, BOJ reversed course, raising the discount rate four times in a 10-month period, with the most recent increase, to 5.25 percent, coming in March 1990 (Table 3).

The accompanying interest rate hikes set off alarm bells among investors. The Nikkei average plummeted from a high of Y38,916 December 29, 1989 to Y28,062 April 2 before staging a partial recovery in the late spring. The Nikkei ended June at Y31,940. During the same period bond prices and the yen followed bumpy paths similar to that of the stock market. The experience suggests that investors became nervous about holding Japanese financial assets. To the extent this was true BOJ had even more reason to worry that any future increases in M2+CDs would fuel inflation in goods and services rather than assets.

Other Issues

The combination of an appreciating yen and monetary expansion required deft BOJ handling. Normally, a looser monetary policy implies a fall in the value of a country's currency as the increased liquidity spills over into international markets, increasing the currency's supply and depressing its value. The yen's appreciation between early 1985 and late 1988 in the face of rapid monetary expansion suggests that BOJ effectively prevented monetary policy from influencing the exchange rate. Some American experts believe that the weakness of the yen from late 1988 to at least mid-1990 reflects a delayed reaction to earlier Japanese monetary policy. However, the yen remains comfortably above rather than below 1985 levels as this theory would predict.

Of course, part of the explanation involves interest rate changes overseas. Despite an accommodating monetary policy in Japan, which by itself would have tended to widen interest rate differentials, interest rate gaps showed an uneven pattern. For example, long-term interest rates in Japan fell in 1986, but U.S. rates dropped even faster. Therefore, while long-term rates were 4.3 percentage points higher in this country in 1985, they were only 2.7 points above Japanese rates the following year, according to calculations by the Bank for International Settlements.[8] As a result, yen-denominated investments became more attractive, boosting the value of the Japanese currency.

This example illustrates the interdependence of monetary policies across countries. Japanese policy, for example, necessarily takes into account foreign factors, whether monetary policies abroad or shifts in the demand for capital in regions such as Eastern Europe. Of course, as the Japanese economy has grown, the effects of BOJ's monetary policy on the rest of the world has increased as well. Federal Reserve Board officials were on record in 1989 as saying that foreign influences on interest rates have complicated their job; similar statements have been heard this year.[9]

In addition to the level of complexity added by the internationalization of financial markets, institutional factors may be complicating the conduct of monetary policy in Japan. Some observers see signs of change in how the Bank of Japan views its role vis-a-vis the Ministry of Finance. Unlike the Federal Reserve Board in the United States, which is independent of the Department of the Treasury, BOJ is tied closely by law and tradition to MOF. As a result, the bank seldom acts independently. Alternate BOJ governors come from MOF; the remainder are promoted from within BOJ itself. The current governor, Yasushi Mieno, is a BOJ man.

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[8] Fifty-Eighth Annual Report (Basle, Switzerland: Bank for International Settlements, 1988), p. 82.

[9] For an econometric measurement of this influence, which presents findings only of the aggregate influence of Japan and nine other industrial nations on U.S. interest rates, see Lawrence J. Radecki and Vincent Reinhart, "The Globalization of Financial Markets and the Effectiveness of Monetary Policy Instruments," Federal Reserve Bank of New York Quarterly Review, Autumn 1988, pp. 18-27.

According to a number of BOJ watchers, the central bank is striving for more independence. In a couple of recent instances involving possible discount rate increases, BOJ and MOF have had what independent observers have interpreted as disagreements about the need for such boosts. (The increases eventually were adopted.) In addition, BOJ reorganized itself at the end of May, establishing new information-collecting capabilities. At least one analyst has speculated that the reorganization was intended to give the bank de facto control over decisions that otherwise might be considered the province of MOF. For its part, MOF in 1989 established a money market monitoring section that one BOJ official described as unnecessary "unless it is meant to monitor the BOJ."

Such tension, if it exists, hardly would be surprising. By their nature finance ministries and central banks are likely to be at loggerheads. Central banks typically see their preeminent role as preventing inflation. Finance ministers (or treasury secretaries), who are likely to be far more attuned to political developments, worry more about avoiding recessions and preventing interest rate increases that they see as harming consumer interests. For example, in early July Treasury Secretary Nicholas Brady said (concerning Fed policies): "It seems to me that it's not a wise idea to emphasize an undying, forever, attack on inflation if it jeopardizes growth in this country."

The national debt often looms large in disputes between the two groups. As the organization charged with financing the national debt, MOF -- like Treasury -- has a direct interest in low interest rates. Central banks put far more weight on the ability to adjust interest rates to a level appropriate to the state of the economy. For example, BOJ has advocated that financing bills be sold at auction. One effect of that action would be to increase the usefulness of this instrument in monetary policy. Currently, BOJ ends up holding a disproportionate share of financing bills because of the low interest rate (high issue price) the bills carry. To date MOF has resisted BOJ's proposal successfully on the grounds that the cost of financing the Japanese national debt would rise.

The two types of organizations are particularly likely to have conflicts over the regulation and the monitoring of financial institutions, for which they share responsibility in both the United States and Japan. This last concern appears to have come to the fore recently in both countries. As BOJ lending to banks has declined in importance, the central bank has sought new ways of exerting its will on the banking system. Under former chairman Paul Volcker the Fed reportedly resisted changes in banking regulations and supervision, whether by shifting responsibility to other government agencies or otherwise, that would have lessened Fed authority. (As of June 1990 the Fed's stance was said to be "evolving.")

Prospects

BOJ has plenty on its plate at the moment. Besides the ever perilous state of money markets, it has a recent reorganization to digest. Some analysts believe the bank is looking over its shoulders at MOF. With respect to the economy, statements by BOJ officials in June suggested they were waiting to see what would happen as a result of the recalibration of monetary policy in the spring. The capacity constraints in the Japanese economy have not disappeared despite continuing high rates of plant and equipment spending. This suggests that BOJ officials will have to tread a fine line between assuring adequate financial resources to accommodate continuing -- albeit slower -- expansion and an excessively loose monetary policy that could set off inflation. Furthermore, sudden lurches in policy could panic investors holding financial and other assets, which remain at very high levels by historical standards.

In monetary policy past events influence the efficacy of proposed policies, making reactions uncertain. For this reason the Bank of Japan finds itself constantly navigating new territory. Furthermore, recent innovations in the instruments of monetary policy put BOJ in the position of making this trip into the unknown using unfamiliar vehicles. Having maintained the Japanese economy on a growth path in the 1980s while avoiding inflation, the central bank has accumulated a strong record of credibility. The bank's reputation probably will grow if, as now appears likely, it successfully meets the challenges of the current decade.

For further information, contact Douglas Ostrom.

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The views expressed in this report are those of the author and do not necessarily represent those of the Japan Economic Institute.

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JEI

REPORT

A Two-Part Report: A and B

NO. 27B
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IN THIS ISSUE:

Tokyo Pursues Independent Path On China At Summit 1
New Twists In MITI's Industrial "Vision" 3
MOF's Financial Liberalization Plans Spark Controversy 4
Japan Ranked Low On Environmental Scorecard 7
Peru's President-Elect Fujimori Seeks Aid From Tokyo 9
Notes: IWC Meeting 12

Tokyo Pursues Independent Path On China At Summit

Tokyo's participation at the July 9-11 summit of the seven major industrial countries in Houston, Texas highlighted a new independence under which Japan may not always follow its allies lockstep on certain international issues. The thaw in East-West relations, which has reduced global military tensions and opened up new avenues for American, European and Japanese political and economic exchanges with the Soviet bloc, increasingly also may create new opportunities for Japanese diplomacy that diverge from the policies of the western industrial democracies.

Reiterating a June 26 announcement, Prime Minister Toshiki Kaifu indicated in a July 7 meeting with President Bush and in subsequent discussions with the other leaders that Japan plans to resume discussions with China on the Y810 billion ($5.4 billion at Y150=$1.00) aid package planned for disbursement over the 1990-95 period (see JEI Report No. 16B, April 20 1990). By this action Tokyo would ease the economic sanctions imposed by industrial countries on international programs now under development, it also suggests that Japan "undertake all feasible measures immediately." Among those measures the council urges:

- An action program between 1991 and 2010 in which Japan would seek to limit greenhouse gas emissions "to the greatest extent possible" and to increase the ecological "sinks," such as tropical forests, that absorb CO_2.

- Promotion of scientific research and monitoring related to global warming.

- Development and transfer to other countries of technologies that can fix, reutilize or in some way diminish the amount of CO_2 and other greenhouse gases in the atmosphere.

The council's plan, being prepared for presentation at meetings of both the United Nations-sponsored International Panel on Climate Change in August and environmental ministers later in the fall, puts Japan at least a step ahead of the United States in seeking adjustments on climate change. But with heavy emphasis on the economic feasibility of emission controls, Tokyo most likely will remain in Washington's shadow for yet awhile longer on environmental issues. However, advances in technology and a desire for improved public ratings may work to ease some of Japan's cautions on addressing climate change.

Pat Murdo

Peru's President-Elect Fujimori Seeks Aid From Tokyo

Peru's president-elect Alberto Fujimori received a warm welcome but only cautious and conditional promises of financial support during his July 1-5 trip to Japan. The sole official present resulting from the visit was a $4.5 million grant. This contrasts with the sizable loan package Tokyo promised Mexico when President Carlos Salinas de Gortari visited in June.

Although Peru is home to Latin America's second-largest Japanese immigrant community, Japan's links with Peru, as with most of Latin America, traditionally have been weak (see JEI Report No. 15A, April 13, 1990). Tokyo disbursed about $28 million in aid to Peru in 1988 (see Table), which represented only 0.4 percent of Japan's total bilateral assistance that year. Furthermore, inflation and the threat of terrorism have made Japanese investors wary of the country. Yet the June 10 election of Mr. Fujimori, the first ethnic Japanese to be elected head of a foreign country, received considerable attention in Japan. During his presidential campaign the former agronomist claimed that his Japanese background would help debt- and inflation-ridden Peru attract significant aid and investment from Japan. It was clear throughout Mr. Fujimori's July visit however, that Japan will not loosen its aid purse strings until Peru meets the demands of its international creditors and adopts an economic reform plan.

The Tokyo meetings were the second part of a pre-inaugural trip aimed at putting Peru on firmer financial footing. Mr. Fujimori's first stop was New York, where he met officials of the World Bank, the International Monetary Fund, the Inter-American Development Bank and the United Nations. Peru's relations with its foreign creditors eroded in 1985 when outgoing president Alan

Japan's Official Development Assistance to Peru and Mexico, 1984-88*

(in millions of dollars)

	Grants			
	Grant Aid	Technical Cooperation	Loans	Total
Peru				
1984	$2.4	$12.3	$10.0	$24.9
1985	1.5	11.8	8.2	21.5
1986	7.6	14.5	10.2	32.3
1987	13.6	18.3	5.7	37.6
1988	7.5	19.3	1.6	28.4
Mexico				
1984	1.6	6.7	22.4	30.6
1985	1.6	9.0	8.9	19.5
1986	---	10.9	69.9	80.8
1987	0.3	17.1	17.6	34.9
1988	1.3	16.7	20.9	38.8

*Net disbursement basis.

Source: Ministry of Foreign Affairs

Garcia limited debt payments to less than 10 percent of the country's annual exports. The IMF and the World Bank responded by making Peru ineligible for new loans. Japan, too, has refused to make additional loan commitments, but it has continued to provide technical assistance and some grant money. President-elect Fujimori has promised to mend relations with international financial institutions. In Tokyo he struggled to convince political and economic leaders that Peru is ready to battle its economic problems. Last year the Latin American nation suffered more than 2,000 percent inflation, while its gross domestic product plummeted by over 12 percent. It now has an accumulated foreign debt of about $17.5 billion.

Prime Minister Toshiki Kaifu promised to send a team of economic advisers to Peru to determine how Tokyo can assist the country most effectively, but he sidestepped Mr. Fujimori's request for significant Japanese financial support. Other Japanese officials also were careful to condition promises of assistance on Peru's fulfillment of its commitments to the international financial community. Akira Nishigaki, head of the Overseas Economic Cooperation Fund, urged Mr. Fujimori to establish the conditions necessary for OECF to assist Peru. Minister of Finance Ryutaro Hashimoto also encouraged the president-elect to institute a revitalization plan for the economy before pressing for Japanese loans. He added that neither OECF nor the Export-Import Bank of Japan could issue loans without IMF approval, which is contingent on Peru adopting a plan for economic reorganization. Mr. Fujimori noted that Lima is ready to resume its dialogue with the IMF but would not necessarily accept the current IMF economic restructuring plan.

Unlike Japan's wait-and-see response to more aid for Peru, it is moving ahead on more help for Mexico. Last September Prime Minister Kaifu visited that country and announced a $1.4 billion debt-relief package (see JEI Report No. 35B, September 15, 1989). The Y122.8 billion ($818.7 million) loan package announced in June includes Y47.3 billion ($315 million) in yen credits from the Export-Import Bank of Japan for a project to refine lead-free gasoline as well as money for an oil-desulfurization plant and funds to rehabilitate railway locomotives. The Export-Import Bank of Japan's confidence in Mexico apparently has persuaded private Japanese banks to follow suit. Nine commercial banks recently announced their intention to join Ex-Im Bank in offering Mexico a total of $345.3 million in loans for a power-generation project.

Hoping to win similar private aid and investment, Peru's president-elect told a group of Japanese business leaders that they need not fear terrorist threats to industry since his administration would guarantee the profits of foreign firms operating in Peru. Mr. Fujimori said his economic revitalization plans include the gradual privatization of more than 200 government-run corporations, a restructuring of the agricultural sector and a bid to double Peru's exports to Japan. Last year Japan imported about $495 million worth of Peruvian goods. Perhaps in response to pressures to get Peru's economic house in order, Mr. Fujimori later outlined additional plans to increase indirect taxes and income taxes for the wealthy, the first specific reform measures he had proposed.

The $4.5 million grant from Tokyo is earmarked to restore an irrigation project in a valley north of Lima, which, until a widespread drought, produced most of Lima's food. Peru probably will have to wait before receiving much more from Japan. According to Mr. Fujimori, IMF officials are set to visit Japan in mid-July to request Japanese assistance in providing stopgap loans to cover Peru's $1.8 billion debt to the IMF, World Bank and Inter-American Development Bank. Japanese government and private-sector fact-finding missions reportedly are scheduled to visit Peru in mid-July and August.

Meanwhile, Lima undoubtedly was keeping a close eye on events at the Houston summit of major economic powers. President-elect Fujimori reportedly asked Mr. Kaifu to call the group's attention to the plight of Latin American debtor nations and to propose a wider framework to help Peru deal with its foreign debts than that outlined by President Bush in his new economic initiative for Latin America. Initial reports from the summit indicated that Japan supported the Bush initiative and is likely to contribute to the $300 million-a-year fund the United States has proposed for the Inter-American Development Bank.

While the election of Mr. Fujimori has resulted in greater play for Peru's problems in Japan, he must be able to go beyond getting attention for his country and, similar to Mexico, take steps toward initiating the economic reforms sought by the international financial community. If he is successful, a perfect match could emerge. Japan is searching for ways to fulfill its international responsibilities as the world's largest aid donor, and Peru is desperately in need of help.

Margo Grimm

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JEI

REPORT

A Two-Part Report: A and B

NO. 28A

July 20, 1990

LAND TAXATION REPORM IN JAPAN

Summary

Land prices in Tokyo and other major Japanese cities have more than doubled since 1986. Although factors ranging from an abundant money supply and strong demand from corporations and individuals for land to ineffective city planning and simple speculation have aggravated the situation, tax policy has come to be regarded as a main trigger of the upward spiral in land prices. Economists and tax experts contend that drastic reforms of the land taxation system not only would increase the supply and the effective use of land within cities but would be an effective prescription for other serious social and economic problems. U.S. government and industry also complain that high land prices work as a structural barrier to the Japanese market.

In response to these concerns the government's Tax Commission set up a subcommittee on land taxation in April. Two months later the group published an interim report proposing higher taxes on land, including idle or underutilized land. Business groups oppose most of the commission's ideas. Government agencies are divided. The Liberal Democratic Party, which has not floated any reform proposals, is scheduled to release a report in December.

The road to reform of the land taxation system is certain to be bumpy. After the government, the LDP and business groups forge a consensus, legislation will be submitted to the Diet next spring. The opposition parties, which control the upper house, gave warning of their response when they blasted the Tax Commission's proposals. The destiny of land taxation reform depends on the balance of power in the Diet, a new phenomenon of the 1990s.

Land Price Increases and Causes

The average price of commercial land in six major cities -- Tokyo, Osaka, Nagoya, Sapporo, Fukuoka and Sendai -- jumped 28.8 percent between March 1985 and March 1986. Increases in ensuing years came in leaps and bounds: 33.8 percent to March 1987, 41.8 percent to March 1988 and 25.1 percent to March 1989 (see Table 1). Caught up in the surge, residential and industrial land prices began climbing in the 1986-87 period and by September 1989 had swelled to levels roughly three times as high as in March 1980. The ripple effect has spread to other urban areas recently (see JEI Report No. 14B, April 6, 1990).

Table 1: Average Land Prices in Six Major Japanese Cities, 1980-89*

(1980 = 100)

End of Month	Commercial	Residential	Industrial
March 1981	108.1	110.6	106.7
March 1982	116.7	117.9	112.6
March 1983	124.6	122.5	116.7
March 1984	135.7	126.8	120.6
March 1985	153.6	133.8	125.0
March 1986	197.9	146.7	131.2
March 1987	264.7	186.3	153.6
September 1987	336.7	216.1	175.4
March 1988	375.2	229.4	183.2
September 1988	420.0	240.0	213.1
March 1989	469.5	264.5	243.7
September 1989	528.8	300.7	279.4

*Tokyo, Osaka, Nagoya, Sapporo, Fukuoka and Sendai.

Source: Japan Real Estate Institute

Although the high cost of land seems to be one of the most serious constraints facing Japan's economy, it is not, in fact, a nationwide problem. The average price of land in all the country's urban districts went up a relatively moderate 65.9 percent between 1980 and March 1989. The problem of high land prices is typically a big city problem.

At the most basic level the run-up in land prices during the second half of the 1980s was the simple result of a mismatch between supply and demand. Factors boosting the demand for land include:

- Office Space - Some analysts link the increasing demand for office space, particularly in Tokyo, with the surge in commercial land prices and, in turn, the jump in overall prices. The Bank of Japan underscored this factor in an April 1990 report that noted that Tokyo's office vacancy rate, one indicator

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of the demand for commercial space, dropped from 1.3 percent in 1981 to 0.8 percent in 1982 and has stayed around 0.2 or 0.3 percent since 1985. The September 1985 Plaza Accord on exchange rates significantly boosted the yen's value; as a result, Tokyo's status as one of the biggest international financial centers rose to that of New York and London. Foreign financial firms flocked to Tokyo to open offices. Companies involved in high technology or service industries, such as software, bioengineering, information and design, also rushed into Tokyo and were in need of office space.

- Money Supply - Other analysts zero in on the expansion of the money supply in the late 1980s to explain the surge in land prices. Kikuo Iwata, an economics professor at Sophia University, compared the relationship between the growth of the money supply and inflation-adjusted gross national product in a recent article in the weekly economic magazine Toyo Keizai. The difference between the two figures in the last half of the 1980s was far less than in the first half of the 1970s, implying that the increase in the money supply in the latter part of the 1980s was restrained given the economy's performance (see Table 2). If, however, the change in the money supply is measured by another indicator, called the Marshallian K, which is obtained by subtracting nominal GNP growth from money supply growth, the number for the 1985-88 period is much bigger than the comparable figures for earlier periods. That indicates that increases in the money supply in the late 1980s were relatively fast.

Table 2: Average Increase in Money Supply in Japan, 1970-88

Period	Money Supply*	Real GNP	Percentage Point Difference	Consumer Prices	Marshallian K**
1970-74	18.8%	6.0%	12.8	10.9%	2.1%
1975-79	12.3	4.7	7.6	7.3	1.5
1980-84	8.9	4.1	4.8	2.6	3.0
1985-88	9.7	4.4	5.3	0.9	4.2

*M2+CDs
**Growth in money supply (M2+CDs) minus growth in nominal GNP.

Source: Kikuo Iwata, Weekly Toyo Keizai, June 16, 1990.

The trend of consumer prices helps to explain the difference between the two series. In the 1970s the big gap between the growth of the money supply and real GNP led to higher prices across-the-board for goods and services. But monetary expansion in the second part of the 1980s did not produce hikes in the consumer price index, mainly because Bank of Japan policy was crafted to prevent inflation (see JEI Report No. 27A, July 13, 1990). Mr. Iwata concluded that the abundant money supply, as measured by the Marshallian K indicator, accelerated the upward spiral of land prices instead of the prices of goods and services. Interestingly, the Bank of Japan admitted in its April report that the increase in the money supply has played a role in the run-up of land prices.

- Speculation - Speculative land transactions also are regarded as factors in the price surge. Because land prices have never fallen in Japan's modern history, individuals as well as businesses strongly believe that, regardless of what happens to the economy, whatever land they buy eventually will increase in value. This expectation has formed the common view that land is one of the best investments for any portfolio.

When commercial land prices began to rise in 1986, the increases quickly amplified the expectation of continuing gains and triggered speculative purchases. This speculation was supported by an abundant money supply and a symbiotic relationship between land and stock ownership. Land ownership gave businesses and individuals the collateral to borrow money to buy high-priced stock, which, in turn, provided the security for speculative land transactions. The April BOJ report supported this causation chain with data on the parallel trend between the growth of loans for real estate and land price increases over the last seven years.

Supply factors contributing to high land prices in Japan include:

- City Planning - In a report released this past May the National Land Agency estimated that 17,400 hectares (42,995 acres) of land in the Tokyo area are idle or underutilized. Of the total, 2,600 hectares (6,425 acres) either are farmed or not used at all. If this land were used for housing, an additional 200,000 to 500,000 apartment units could be built in the Tokyo area.

Moreover, land currently zoned for residential use is underutilized, according to estimates by the Tokyo metropolitan government. The Building Standards Law sets the occupancy rate for each apartment building or house as the ratio of living space to total land. The average maximum legal occupancy rate in metropolitan Tokyo was set at 2.43 in 1988, meaning the typical landowner could build 2,187 square feet of living space on a 900-square-foot plot. The actual average ratio was only 0.993 (40.9 percent of the maximum legal ratio), the Tokyo metropolitan government calculated. The counterpart to this figure is the large number of single-family homes and low-rise apartment buildings even in central Tokyo, where high-rise apartments would provide a better land-use option. The Ministry of Construction puts the average number of stories for commercial buildings, apartment houses and homes in the Tokyo area at 2.5.

- Taxation - Yukio Noguchi, an economics professor at Hitotsubashi University, estimated the effective rate of the country's real estate tax, the key tax for property owners, was only 0.06 percent of actual land prices in Tokyo in FY 1987. Inheritance and capital gains taxes on land transactions also are maintained at very low levels. Japan's tax code, in short, appears to provide no prod to put land on the market.

- Other Laws - The Land Lease Law and the House Lease Law play a role in the limited supply of rental housing. These similar laws, enacted in 1921, virtually prevent an owner from evicting a tenant for either economic or social reasons. Once a tenant obtains a lease for a house or an apartment he or she can expect to stay there even after the original contract expires since the House Lease Law basically forces the owner to renew the lease. Moreover, given the tenant's upper hand, rents generally remain low.

Many property owners think the two laws are too rigid. They are cited as a major reason landowners are very reluctant to build rental housing. In a mid-September 1989 article in Economist, a Japanese-language weekly magazine, Yutaka Harada, an economist at the Economic Planning Agency, noted that these laws were amended in 1941 to enable soldiers returning from World War II to find their families easily. However, the two pieces of legislation have remained unchanged for 45 years. Mr. Harada contended that revision of the laws to allow owners to evict tenants for economic reasons is necessary to solve the problems of high housing and land prices.

Economic Results of Rising Land Prices

Rapid increases in land values have brought huge capital gains, whether realized or not, to property owners. This is said to have caused a widening gap in wealth distribution between Japan's haves and have-nots and heightened the perception of growing inequality among income levels. Mr. Noguchi of Hitotsubashi University estimated that the average price of a parcel of land in Tokyo jumped 2.5 times in the 1986-87 period. Those same years saw a 10 percent increase in wages and salaries as determined by the shunto spring wage negotiations. Even that boost was believed to be too small for anybody dependent largely on a job for income to buy a house in the Tokyo area. Although more than 64 percent of the households in the Tokyo area own a house or a condominium, future homeowners see few possibilities for buying there without either winning a lottery, speculating in the stock and bond markets, becoming the head of a major company or simply inheriting from parents.

The notion of inequality was strengthened in mid-April when the National Land Agency reported new data on the unrealized capital gains of corporations on land. NLA estimated that land owned by corporations had a market value of Y514.5 trillion ($3.4 trillion at Y150=$1.00) in 1988 compared with a book value of Y80.6 trillion ($537.3 billion). Simple arithmetic indicates that corporations enjoyed unrealized capital gains of Y433.9 trillion ($2.9 trillion) simply by holding land.

Not having to pay taxes on the unrealized capital gains earned by their land-holdings is just one advantage corporations have over individuals who inherit land and have to pay capital gains taxes, although the rates admittedly are low. The increasing market value of land held by firms helped push up their stock prices in the late 1980s. Moreover, companies used their land-holdings valued at market prices as collateral in borrowing money for other ventures, including stock market speculation.

The upward spiral in land prices also has an impact on such things as fixed government investment, the savings rate and Japan's current account imbalance. In the recently released final report on the Structural Impediments Initiative Tokyo promised to spend Y430 trillion ($2.9 trillion) for public investment over the FY 1991-FY 2000 period (see JEI Report No. 26B, July 6, 1990). Although the Ministry of Finance has not disclosed how it plans to divide spending among housing, water supplies, sewers, parks and other forms of social overhead capital, a considerable part of the total no doubt will have to be earmarked to buy land in major metropolitan areas. Thus, the impact of the 10-year public investment program on the quality of life in Japan will not be as great as the spending figure might indicate. In addition, MOF worries that outlays of the magnitude pledged could rekindle inflation, if the economy remains relatively buoyant, and that government purchases could give an extra boost to land prices.

High land prices also are regarded as affecting the U.S.-Japan trade imbalance in some ways. Many foreign companies complain that the high cost of commercial space in Tokyo keeps them from opening offices or sales subsidiaries in this preferred location. The result is lower sales of foreign goods in the lucrative Japanese market. In addition, the high price of land is a key factor in the often significant differences in consumer prices between Japan and the United States (see JEI Report No. 4A, January 26, 1990).

Another effect of rising land prices is to raise the prices of goods and services -- whether domestic or foreign -- in Japan, resulting in lower demand than otherwise and probably consumption as well (depending on the price elasticity of each product and service). Low consumption (which, in the Japanese context, translates into relatively high savings) increases the imbalance in the current account. By reducing land prices, some economists think, Japan can trim its high national savings rate and cut its current account surplus over the long term. Their reasoning is straightforward. One of the primary reasons for saving in Japan is to buy a fixed asset, such as a house or a condominium, which can be transferred to the next generation through inheritance. Therefore, this group of economists considers it possible to lower the personal savings rate by bringing down land prices, which reduces the cost of the targeted fixed asset -- a home.

Other economists suggest that a reduction in land prices would decrease rather than increase demand for land and/or housing in both the short and the medium run and, thus, boost net savings (savings minus investment). This group points to the fact that rising land prices historically have accompanied an upswing in demand for housing, while stagnant prices have corresponded with periods of recession. Therefore, it is inconclusive whether or not a drop in Japanese high land prices would decrease net savings and cut the current account surplus.

Land Taxation in Japan

Among the various taxes on land in Japan (see Table 3) those considered to have the greatest impact on the supply of land are the fixed assets, inheritance and capital gains taxes. The fixed assets tax (otherwise known as the real estate tax) is calculated by multiplying the "registered" market value of a property by a rate between 1.4 and 2.1 percent, depending on the municipal government. (The registered market value is the assessed value of the property.) Although the Ministry of Home Affairs reestimates registered market values every three years, critics point out that assessments are maintained at about 30 percent of the benchmark prices estimated by the National Land Agency. Moreover, many experts calculate that benchmark prices themselves are about 70 percent of actual land prices. That means that assessments represent only about 20 percent of actual prices.

The Home Affairs Ministry counters that the fixed assets tax should not be based on actual prices since it reflects the concept of "rents" -- in other words, the tax is a payment for the services provided to the property owner by the municipal government. For example, if transportation services were improved in a specific area, the tax on land in this area would go up by the amount of the anticipated benefit the landowner receives from better transportation services. Using this rationale, the Home Affairs Ministry thinks registered market values should be different from either benchmark prices or actual market

Table 3: Real Estate Taxes in Japan

Taxpayer	Tax	Tax Basis	Tax Rate (standard)	Jurisdiction
Registered owner	Fixed Assets Tax	Registered market value	1.4%	Municipal government
	City Planning Tax (in designated areas only)	Registered market value	0.3%	Municipal government
	Special Tax on Land-Holdings	Acquisition price	3.0% or 1.4%	Municipal government
Heir	Inheritance Tax	Market value	Progressive (10%-70%)	National government
Donee	Gift Tax	Market value	Progressive (10%-70%)	National government
Purchaser of real property	Real Property Acquisition Tax	Market value	4.0%	Prefectural government
	Special Tax on Land-Holdings	Acquisition price	3.0% or 1.4%	Municipal government
Applicant for registration	Registration and License Tax	Market value	5.0% (heir: 0.6%; donee or legatee: 2.5%)	National government (registration office)
Seller (individual)	Income Tax	Long-term	20.0%	National government
		Short-term	40.0%	National government
	Inhabitant's Tax	Long-term	6.0%	Municipal and prefectural governments
		Short-term	12.0%	Municipal and prefectural governments

Source: Ministry of Finance, Guide to Japanese Taxes 1989-90.

prices, both of which are affected by speculation and/or the misalignment of supply and demand. This consideration leads to a substantially lower tax burden for property owners than if other valuation bases were used.

The tax burden is reduced in two other ways. To protect owners of real estate smaller than 200 square meters (2,153 square feet) from the tax consequences of a rapid increase in land prices, the tax basis was reduced to one-fourth of assessments in 1974. Another adjustment has been in effect since 1964. If the assessment on any piece of residential land does not increase at least 30 percent during the Home Affairs Ministry's three-year reestimation period, the tax basis for the property will be raised only 10 percent. Increases in the tax base of 15, 20, 25 and 30 percent correspond to increases in registered market values of 50, 70, 90 and more than 90 percent, respectively.

The actual real estate tax burden on land smaller than 200 square meters that experienced a rise in assessment of less than 30 percent over three years can be calculated as follows:

1. Actual market price x 70 percent = NLA's benchmark price
2. Benchmark price x 30 percent = registered market value
3. Registered market value x 25 percent (to reflect the first adjustment measure) x 85 percent (15 percent reduction to reflect the second adjustment measure) = tax base
4. Tax base (4.5 percent of actual market price) x 2.1 percent tax rate (for example) = effective tax rate of 0.09 percent.

Mr. Iwata of Sophia University estimated that the effective rate of the fixed assets or real estate tax in FY 1989 was 0.07 percent in metropolitan Tokyo and 0.14 percent on average in Japan. That compared with effective property tax rates of 1.42 percent in New York City, 1.99 percent in Chicago and 0.66 percent in Los Angeles in 1984. He concluded that the extremely low effective rates of Japan's real estate tax are the main cause of the inadequate supply of property on the market.

The country's inheritance tax also provides special advantages for bequests of land. The tax is based on the National Tax Administration Agency's study of price changes for land abutting main roads in Japan's 47 prefectural capitals and the 516 districts where NTAA has local offices (see JEI Report No. 5B, February 2, 1990). Hitotsubashi University's Noguchi estimated that the NTAA ratings are 30 percent below NLA benchmark prices and about 50 percent of actual market prices. In addition, under a special provision in effect since FY 1989, the valuation base for the inheritance tax is reduced by half for property measuring less than 200 square meters.

Another inheritance tax break is the basic estate allowance, which equals Y40 million ($266,700) plus Y8 million ($53,300) multiplied by the number of heirs. Suppose a son inherits a house and land in central Tokyo with a market value of Y200 million ($1.3 million). NTAA values the property at Y100 million ($667,000) based on the above-mentioned criteria. Since housing prices in central Tokyo are extremely high, a Y200 million ($1.3 million) home most likely is on a lot of less than 200 square meters. Thus, the valuation basis would be decreased to Y50 million ($333,300) because of the special treatment accorded small pieces of property under the inheritance tax law. Since, as the sole heir, the son can deduct the Y48 million ($320,000) basic estate allowance from the original tax base, his inheritance tax is calculated on the basis of Y2 million ($13,000). With a 10 percent tax rate (the rate applied for small inheritances), he will pay only Y200,000 ($1,300) in inheritance taxes on a Y200 million ($1.3 million) property in central Tokyo. The effective tax rate is 0.1 percent.

If the tax break for property measuring less than 200 square meters were eliminated, the son would pay nearly Y16.7 million ($111,000) in inheritance taxes on the property. If NTAA's rating price were increased to the actual market price after abolishing the tax break, his tax payment would jump to almost Y67.8 million ($451,700). Professor Noguchi recommended tnat inheritance taxes be raised by eliminating the tax break and increasing NTAA's rating price.

Capital gains from property transactions are taxed in two ways. Gains from selling land purchased within the past five years (short-term gains) are heavily taxed to restrain the speculative transactions that have cropped up in recent years. A tax rate of 40 percent is applied to an individual's capital gains. Corporations face an additional 30 or 20 percent tax bite, added to the normal corporate income tax rate, depending on whether the asset was held for two or five years, respectively. If the property was held for more than five years (long-term gains) and the capital gains are less than Y40 million ($266,700), the tax rate drops to 20 percent. Capital gains of more than Y40 million ($266,700) are subject to a 25 percent rate.

It is important to note that the capital gains tax is levied only when a piece of property is sold -- in other words, on realized gains. This aspect of the tax code is one of the reasons given for the limited amount of land on the market: many owners are holding on to their property because it is likely to continue to appreciate in value. If capital gains, realized or not, are calculated using market prices, the corresponding tax would be similar to land-holding taxes based on actual market prices. Several experts are studying the possibilities of integrating the capital gains tax with various land-holding taxes.

Idle or underutilized land also is taxed in two ways. A special land-holding tax has been levied since 1974 on property that the local government has designated as idle or underutilized land. A 1.4 percent tax is levied on the transaction value (acquisition cost) rather than the registered market value as in the case of the real estate tax. (The fixed assets tax, however, is deductible.) The Ministry of Construction has criticized the special land-holding tax on the grounds that it has not increased the supply of land on the market or improved land usage. MOC reasons that the economic criteria used by municipal governments in designating land as idle or underutilized is ambiguous. Moreover, the effective tax rate is low relative to the real estate tax. MOC also points out that only land purchased after 1968 is subject to the special tax. However, this tax does not get the spotlight in the debate over taxation of idle or underutilized land.

A prime target in that debate is agricultural land within city confines. Current law requires that farm land within what are known as Urbanization Promotion Areas be taxed in the same manner as residential land for the real estate and the inheritance taxes. But if a farmer says he or she plans to continue to cultivate land for 10 years or more and the local government verifies that fact, the land is taxed at a rate deeply discounted from the residential rate; only when the farmer stops cultivating the land is it taxed at the residential rate.

According to the Construction Ministry, continuously cultivated farm land accounted for 23,395 hectares (57,809 acres) or 83 percent of the agricultural land in the Tokyo area in 1988. Mr. Iwata of Sophia University estimated that farmers who win the tax break pay only one-tenth to one-thirtieth of the real estate tax paid by owners of residential land. This works out to a 0.0045 percent effective tax rate in Tokyo, the professor said. An econometric analysis he did indicated that if Kanagawa prefecture (next to metropolitan Tokyo) had abolished the tax break for farmers in 1976, land prices 10 years later would have been 28 percent lower than otherwise. Mr. Iwata concluded that there is no economic rationale for preserving agricultural land in such major metropolitan areas as Tokyo, Osaka and Nagoya. The Ministry of Construction has forecast that if 10,000 hectares (24,710 acres) of agricultural land in urban areas were used for housing, an extra 1 million homes and apartment units could be added by the year 2000.

Tax Commission's Interim Report

The land taxation subcommittee of the government's Tax Commission, which began hearings May 13, submitted an interim report June 22 (see JEI Report No. 21B, May 25, 1990). The group, which is looking into reform of the fixed assets or real estate tax, taxation of agricultural land and the inheritance tax, plans to submit a final report by the end of October. It will be taken up, in turn, by the Tax Committee of the ruling Liberal Democratic Party.

The interim report points out future directions of land taxation reform, including the possibility of:

- Strengthening the taxation of property owners. Considered as alternatives to current taxes are a new flat, relatively low tax to be imposed on all land or, if that is not possible, a new special tax applicable to land held by corporations; a stiffer tax on idle or underutilized land; a higher tax on large land-holdings; and a steeper tax on property that has appreciated rapidly in recent years.

- Taxing capital gains even if they are not realized.

- Having the national government levy a land-holding tax comparable to the real estate tax imposed by local governments.

- Increasing assessments used to calculate real estate taxes so that the tax basis corresponds more closely with actual market prices.

- Raising the tax on agricultural land inside cities for both real estate and inheritance tax purposes.

- Increasing assessments under NTAA's rating system in order to boost inheritance taxes.

- Increasing the rate of the special land-holding tax on idle or underutilized land.

- Decreasing the corporate and/or the personal income tax burden at the same time taxes on land are increased to keep the tax system revenue neutral under land taxation reform.

Conclusion

The business community has registered its opposition to most of the ideas floated by the government's land taxation group. Keidanren (Japan Federation of Economic Organizations) published a position paper on land taxation reform in mid-May. It came out against the suggested flat property tax (including the variant of a special tax on land owned by corporations) and the proposed tax on unrealized capital gains on land, both of which would hit companies as well as individuals. But Keidanren supported higher taxes on idle or underutilized land and on agricultural land. Not surprisingly, the farm bloc opposes several of the ideas outlined by the government's land taxation group.

Government agencies are divided on land taxation reform. The National Land Agency is said to be a strong advocate of the suggested flat tax on land and the proposed tax on unrealized capital gains. But the land taxation group's ideas may face opposition from the Ministry of International Trade and Industry, which frequently defends the interests of small and medium-sized companies. The Ministry of Construction is stressing higher taxation of idle or underutilized land and agricultural land. The Ministry of Home Affairs and local governments do not think it is right to increase real estate taxes in the hope that a larger amount of land will be placed on the market. The Ministry of Agriculture, Forestry and Fisheries naturally does not want drastic changes in the tax system for the agriculture sector, but it admits that something might have to be done about the tax treatment of farm land within city areas.

The LDP has given no hints about how it is leaning on land taxation reform. It is said that the ruling pary's tax reformers are emphasizing effective land use, better city planning and an overhaul of the Land Lease and the House Lease Laws rather than a drastic change in land taxation. But the opposition parties, in particular the Japan Socialist Party, contend that high taxes on the business sector's unrealized land-related capital gains is necessary. They also think it is appropriate to equalize the actual market price, the registered market value used for real estate taxes and the valuation derived from NTAA's rating system for inheritance tax calculations.

Although land taxation reform has generated heated discussions in Japan in recent months, no consensus has yet arisen. Political analysts estimate that some change in property taxes is inevitable, given public dissatisfaction, foreign complaints and economic rationales. But it remains premature to predict how and when the reforms will be accomplished.

For further information, contact Hideo Takahashi.

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The views expressed in this report are those of the author and do not necessarily represent those of the Japan Economic Institute.

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JEI REPORT

A Two-Part Report: A and B

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Kaifu Gets High Marks For Summit Performance 1

House Panel Examines Alleged Tax Underpayment ... 3

Yen Recovers Some Lost Ground 6

Japanese Savings Remain At High Level 7

Foreign Direct Investment
In Japan Up And Down 9

Kaifu Gets High Marks For Summit Performance

Prime Minister Toshiki Kaifu generally received high marks from Japanese business leaders and ruling Liberal Democratic Party officials for his participation at the July 9-11 summit meeting of the seven major industrial nations. Specifically, the prime minister was lauded for upholding Japan's interests with respect to China and the Soviet Union. With an eye toward continuing protection of Japan's rice market, Mr. Kaifu also secured inclusion of a clause in the final communique stating that global negotiations aimed at liberalizing trade in agricultural products should "take into account [countries'] concerns about food security."

There are concerns in Tokyo, however, that as the December deadline approaches for conclusion of the Uruguay Round of multilateral trade talks, the prime minister no longer will be able to resist pressures from the United States and other trading partners to open up Japan's rice market. Thus, while Mr. Kaifu put in a commendable performance at the Houston, Texas meeting -- demonstrating to both domestic and international audiences that he has the leadership capabilities to hold his own with experienced heads of government -- the true test of his staying power will come later this year.

are waiting to see what role tax revenues from the U.S. subsidiaries of Japanese businesses will play in the U.S. budget problem.

Margo Grimm and Hideo Takahashi

Yen Recovers Some Lost Ground

Up, down or sideways? Currency traders in 1990 can be forgiven for not always being sure which direction the foreign exchange market is heading. By mid-July the yen was much stronger than it had been in April, when it bottomed out near Y160=$1.00 after zigzagging down since December 1988. On July 13 the yen closed in New York at Y148.15 after going up to Y146.6 during the day, the highest value it had reached since February. However, 1990 as a whole is shaping up as even worse for the yen than last year, when its average value declined to Y137.96, or 7.1 percent below 1988's all-time annual high of Y128.15. With less than half the year to go, the yen has yet to approach its 1989 average value, even temporarily.

The relative weakness of the Japanese currency is even greater when viewed in inflation-adjusted terms (see Table). At its three-year nominal low in April 1990 the Japanese currency was a mere 3.8 percent stronger than its 1985 average real value based on an International Monetary Fund measure of the real value of the yen. This result suggests that the yen had given up virtually all the real gains it made against the dollar between 1985 and 1988. Had the yen sunk below Y170, the Japanese currency would have been lower than any annual real level since 1982, when it reached a record low by this measure.

Nominal and Real Values of the Yen Against the Dollar, 1983-90

(average for the period)

		Nominal	Real*
1983		Y237.5	101.7
1984		237.5	102.7
1985		238.5	100.0
1986		168.5	121.0
1987		144.6	124.2
1988		128.2	133.2
1989		138.0	127.2
1990	January	145.1	114.3
	February	145.5	113.1
	March	153.1	108.4
	April	158.5	103.8
	May	153.5	n.a.
	June	153.8	n.a.

*An index based on unit labor costs and nominal exchange rates weighted by disaggregated trade levels in manufactured goods in 1980 and set at 100 in 1985.

Source: International Monetary Fund and Nihon Keizai Shimbun

In real terms the Japanese currency in mid-July was still further from its all-time high than its record low. With inflation and productivity trends suggesting that an appreciation of the yen's nominal value is necessary just to maintain its real value, a move to around Y140=$1.00 would be required to restore the yen's real value to the pre-1985 annual high achieved in 1978. A bigger appreciation to under Y120=$1.00 would put the Japanese currency in its adjusted 1988 range.

Policy in Washington and Tokyo may be partly responsible for the yen's recent strength. Federal Reserve Board chairman Alan Greenspan admitted in mid-July that the Fed has moved recently to reduce interest rates in this country, although subsequent Fed pronouncements downplayed this apparent policy shift. The Bank of Japan has given absolutely no indication that it plans to follow the Fed's lead; if anything, BOJ may even tighten monetary policy beyond the moves it took this spring (see JEI Report No. 13B, March 30, 1990). Japan's central bank has managed to distill some bad news from generally favorable price reports. (Wholesale prices were actually lower in June 1990 than the year before.) It noted that the prices of services, which, as a labor-intensive activity, presumably reflect the much-feared labor shortage in Japan more than wholesale prices, have risen sharply in recent months. Partly for this reason, BOJ sees no reason to drop its guard against the perceived serious threat of inflation.

Taken together, BOJ and Fed actions suggest that the short-term interest rate gap on Euroyen and Eurodollar three-month instruments, which stood at a mere 0.6 percentage point in mid-July, could narrow even more. Should this happen, the yen can be expected to strengthen further against the dollar. At most, Japanese investors would have to pay a small interest rate penalty in exchange for the elimination of currency-exchange risks in keeping their funds at home; that would reduce the supply of yen on the foreign exchange market and the demand for dollars. Already some Japanese analysts worry that the virtual disappearance of the interest rate differential on yen and dollar instruments, coupled with an already rising yen, could precipitate a stampede toward the Japanese currency at the expense of the dollar. While these same analysts believe BOJ probably could rein in such movements, the twists and turns of the yen during the past five years have been enough to buck some of the most experienced riders.

Douglas Ostrom

Japanese Savings Remain At High Level

Two recent reports give weight to the general impression of Japanese individuals as world-class savers. The Bank of Japan's annual flow of funds report shows that households in Japan significantly increased the net supply of savings available to other domestic sectors and to overseas borrowers in 1989 from the scaled-back levels of 1987 and 1988 -- talk of Japan's falling personal savings rate notwithstanding (see Table). Nonfinancial businesses, which dramatically increased plant and equipment spending in the late 1980s, boosted their demand for funds from the rest of the economy last year. The foreign sector, where a negative number indicates a net flow to overseas investors, continued to decline in importance, reflecting the steady reduction since the mid-1980s in Japan's current account surplus.

Japan's Flow of Funds, 1983-89

(percent of nominal gross national product)

	1983	1984	1985	1986	1987	1988	1989
Nonfinancial Corporations	-3.0%	-1.7%	-1.9%	-1.3%	-2.2%	-4.6%	-6.9%
Households	10.3	9.8	9.8	10.2	7.9	7.6	9.3
Public Sector	-6.8	-5.8	-4.2	-4.2	-1.4	0.6	0.6
Overseas	-1.8	-2.8	-3.6	-4.3	-3.6	-2.8	-2.0

Notes: A positive figure indicates that the sector was a net supplier of funds to the remaining sectors.

Financial institutions are excluded.

Source: Bank of Japan

A second survey by the Management and Coordination Agency provided details of the composition of financial and nonfinancial assets in Japanese households. In 1989 the average household had savings of Y10.9 million ($72,667 at Y150=$1.00), 1.6 times the level of the previous survey in 1984. While savings held in the form of stocks and bonds grew faster than financial assets in general, securities still accounted for only 25.6 percent of the typical household's financial assets last year against 42 percent for time deposits and 22.2 percent for insurance.

While American households might be boggled by the ability of their Japanese counterparts to maintain such high levels of savings, they are likely to be far less impressed by what is in the average Japanese home. Certainly, Japanese and U.S. data support the notion that the two countries are among the world's wealthiest. For example, well over 90 percent of households in both countries have color television sets. Similarly, nearly every household in the two countries has one or more refrigerators, and large numbers have air conditioners. Like their American counterparts, Japanese households often own the newest gadgets turned out by the nation's electronics powerhouses; last year 17.5 percent had video cameras, up from 4.7 percent in 1984.

In some respects, however, American households appear to be much more affluent. While both groups of households generally have washing machines, for example, the typical Japanese appliance requires manual operation, as did machines that disappeared from U.S. homes a generation ago. Fully automatic machines were in only 35 percent of Japanese households in 1989, up from 28 percent in 1984 and 30 percent in 1979. Even the latest figures for automatic machines are roughly half the corresponding figures for the United States and West Germany.

In addition, the Management and Coordination Agency statistics show that cramped housing in Japan may be exacerbating some differences between Japanese households and those in other industrialized countries. (For details of Japanese housing, see JEI Report No. 30A, August 4, 1989.) Beds and sofa beds were found in 47.3 percent of Japanese households in 1989, down from 50 percent five years earlier. Presumably Japanese families are finding that space in their crowded homes can be used more efficiently if they use Japanese-style bedding, which easily can be stored in a closet during the day, rather than bulkier Western-style beds. In short, the data in these surveys present a picture of the Japanese consumer with spending and savings patterns different from those in most industrialized countries -- and not necessarily converging toward those patterns.

Douglas Ostrom

Foreign Direct Investment In Japan Up And Down

Unlike the across-the-board growth shown for Japanese direct investment abroad (see JEI Report No. 23B, June 15, 1990), the figures on foreign direct investment in Japan for the year ending March 31, 1990 were mixed. Despite a 33.3 percent jump in the number of direct investments flowing into Japan in FY 1989, the value of investment fell 11.8 percent in dollar terms compared with the previous fiscal year. FY 1989 also saw an abrupt reversal of the division of investment between the manufacturing and the nonmanufacturing sectors.

For the first time in several years the amount of new foreign direct investment going into Japan declined in FY 1989, despite a generally weaker yen. According to Ministry of Finance data, foreigners added just under $2.9 billion to their holdings in Japan in FY 1989 compared with more than $3.2 billion in the April 1988-March 1989 period (see Table 1). The cumulative gross book value of foreign direct investment stood at more than $15.6 billion on March 31, 1990. The number of investments, in contrast, rose from 4,268 in FY 1988 to 5,688 in FY 1989. The average value of each investment, therefore, fell from $759,840 to $502,813. The decline could be a result of an increased number of smaller firms trying to establish a presence in Japan and/or a lack of large investments.

Table 1 also shows a surge in the borrowing (loans and bond issues) in FY 1989 to advance into Japan, although equity capital remained the dominant method of entry. Loans jumped from $667 million to $919 million or 32.1 percent of all investment. Equity capital fell from $2.6 billion in FY 1988 to $1.9 billion in FY 1989 but still financed 67.9 percent of all foreign inward investment. These data also underscore the trend toward smaller investments. The average value of an investment funded by an investor's own money fell from $608,121 in FY 1988 to $344,271 in FY 1989, while the corresponding figures for the borrowing category were $20.8 million and $18.4 million.

By country the United States remained the largest source of foreign direct investment in Japan at $1.6 billion, accounting for 57.4 percent of FY 1989's total value, well above its 54.7 percent share the previous year (see Table 2). U.S. investment followed the overall pattern: the number of investments rose (from 670 to 727), while their total value was down (off 7.4 percent).

Other investors changed their rankings for the most part. Switzerland, which held the number-two spot in FY 1988, changed places with the Netherlands,

Table 1: Trends in Foreign Direct Investment in Japan, FY 1951-FY 1989

(number of cases and millions of dollars)

Fiscal Year	Equity Capital Cases	Equity Capital Amount	Loans and Bonds Cases	Loans and Bonds Amount	Total Cases	Total Amount
1951-80	8,826	$2,979	n.a.	n.a.	8,826	$2,979
1981	919	432	n.a.	n.a.	919	432
1982	1,052	749	n.a.	n.a.	1,052	749
1983	2,363	813	n.a.	n.a.	2,363	813
1984	3,685	493	n.a.	n.a.	3,685	493
1985	3,322	780	48	$150	3,370	930
1986	3,045	760	34	180	3,079	940
1987	3,912	1,453	34	761	3,946	2,214
1988	4,236	2,576	32	667	4,268	3,243
1989	5,638	1,941	50	919	5,688	2,860
Total	36,998	12,976	198	2,677	37,196	15,654

Source: Ministry of Finance

Table 2: Foreign Direct Investment in Japan by Country, FY 1988-FY 1989

(in millions of dollars)

	FY 1988			FY 1989			Cumulative March 31, 1990		
	Cases	Value	Share	Cases	Value	Share	Cases	Value	Share
United States	670	$1,774	54.7%	727	$1,642	57.4%	7,681	$7,910	50.5%
Canada	98	22	0.7	83	35	1.2	672	187	1.2
United Kingdom	447	112	3.5	495	81	2.8	3,226	599	3.8
West Germany	239	195	6.0	365	144	5.0	2,028	690	4.4
France	223	27	0.8	388	25	0.9	1,993	227	1.5
Switzerland	303	273	8.4	403	87	3.1	2,278	1,015	6.5
Netherlands	351	157	4.8	735	248	8.7	2,133	730	4.7
Other Europe	181	52	1.6	193	40	1.4	1,778	377	2.4
Hong Kong	386	44	1.4	445	63	2.2	4,011	453	2.9
Japan*	411	306	9.4	333	198	6.9	3,391	1,851	11.8
Other	959	280	8.6	1,521	297	10.4	8,005	1,615	10.3
Total	4,268	3,243	100.0	5,688	2,860	100.0	37,196	15,654	100.0

*Investments by Japanese firms with significant foreign participation.

Source: Ministry of Finance

which had been fourth-ranked. West Germany held on to third, although its 239 investments worth $195 million in FY 1988 formed 6 percent of the total, while its 365 investments valued at $144 million in FY 1989 were good for only a 5 percent share. Investment from the United Kingdom fell 27.7 percent in value, but the number of investments rose slightly from 447 to 495. Investment from Hong Kong grew in both value and number, the exact opposite of reinvestment by existing Japanese subsidiaries of foreign firms, which dropped in both value and cases.

It is interesting to note that based on the number of investments the Netherlands actually outranked the United States (735 to 727) in FY 1989 and that the number of investments from "other" countries grew a sharp 58.6 percent. The country data show even more clearly the pattern of smaller investments as most countries registered a greater number of transactions but posted a decline in the total value. From this one can surmise that a presence in the Japanese market is becoming more essential to an increasing number of businesses around the globe.

An analysis by industry shows a startling shift in the balance between foreign direct investment in manufacturing compared to nonmanufacturing (see Table 3). The manufacturing sector attracted 74.8 percent of all foreign investment in FY 1988 but only 41 percent the following year. Consequently, the nonmanufacturing sector's share of the total value of annual investment rose from 25.2 percent to 59 percent. Sharp declines in investment in chemicals (down 59.4 percent), machinery (-53.3 percent) and food processing (-80 percent) were the main reasons manufacturing recorded a decline. Only the metals industry showed a significant gain (37.9 percent).

Table 3: Foreign Direct Investment in Japan by Industry, FY 1988-FY 1989

(in millions of dollars)

	FY 1988			FY 1989			Cumulative March 31, 1990		
	Cases	Value	Share	Cases	Value	Share	Cases	Value	Share
Manufacturing	1,715	$2,425	74.8%	2,066	$1,172	41.0%	16,754	$10,202	65.2%
Food	122	86	2.7	126	17	0.6	1,130	283	1.8
Textiles	16	1	0.0	13	0	0	171	51	0.3
Rubber and Leather	1	0	0.0	34	29	1.0	120	76	0.5
Chemicals	181	500	15.4	194	203	7.1	2,217	2,722	17.4
Petroleum	37	27	0.8	24	8	0.3	465	692	4.4
Nonmetallic Mineral Products	9	11	0.3	8	6	0.2	375	141	0.9
Metals	11	29	0.9	187	40	1.4	867	497	3.2
Machinery	1,103	1,732	53.4	1,093	808	28.3	9,388	5,370	34.3
Other	235	39	1.2	387	61	2.1	2,021	370	2.4
Nonmanufacturing	2,553	818	25.2	3,622	1,688	59.0	20,442	5,452	34.8
Construction	134	8	0.2	419	9	0.3	1,170	82	0.5
Real Estate	72	70	2.2	121	647	22.6	374	794	5.1
Commerce	1,177	454	14.0	1,710	544	19.0	10,821	2,213	14.1
Services	971	152	4.7	972	138	4.8	5,521	798	5.1
Transportation	36	2	0.1	149	47	1.7	419	127	0.8
Communications	33	40	1.2	14	23	0.8	100	127	0.8
Banking and Insurance	14	61	1.9	40	180	6.3	247	572	3.7
Other	116	31	1.0	197	100	3.5	1,790	739	4.7
Total	4,268	3,243	100.0	5,688	2,860	100.0	37,196	15,654	100.0

Note: Totals may not add up due to rounding.

Source: Ministry of Finance

Sharp increases in funds flowing into real estate (from $70 million to $647 million), commerce (from $454 million to $544 million), transportation (from $2 million to $47 million) and banking and insurance (from $61 million to $180 million) accounted for the nonmanufacturing sector's new dominance. Only investments in general services (from $152 million to $138 million) and communications (from $40 million to $23 million) showed sizable declines.

Some caveats to the data should be noted. The declining value of the yen between FY 1988 and FY 1989, particularly against the U.S. dollar and the West German mark, distorted the true picture. Against the dollar the yen fell to Y142.83 in FY 1989 from Y128.26 in FY 1988 and against the deutsche mark it dropped to Y84.78 from Y71.14. Moreover, the data are based on notifications to the Bank of Japan and the Ministry of Finance; the reported values may not have corresponded to actual transactions and some of the planned investments might have fallen through.

The strong rise in the number of investments indicates either greater interest in the Japanese market on the part of smaller firms and companies from a broader range of countries or a decline in the number of large investments compared to previous years. The data appear to point to a mix of both. It is too early to tell if the proliferation of smaller investments and the shift between manufacturing and nonmanufacturing mark the start of new patterns or are simply one-year aberrations.

Jon Choy

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The views expressed in this report are those of the authors and do not necessarily represent those of the Japan Economic Institute.

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REPORT

A Two-Part Report: A and B

NO. 29A July 27, 1990

TRILATERAL TIES: JAPAN, THE UNITED STATES AND THE PHILIPPINES

Summary

Bilaterally as well as trilaterally the Philippines has unique ties with Japan and the United States. But changes in the global political environment, including perceptions of a decreased Soviet threat and the needs of newly emerging democracies in Eastern Europe, have diverted attention from the Philippines. Yet the enormity of its problems, ranging from heavy foreign debt and political instability to poverty and hunger, demand particular attention from Japan and the United States.

Determining the most effective means of supporting this complex country has not been simple. A multilateral economic assistance program and negotiations for U.S. base rights in the Philippines have brought new challenges to the trilateral relationship. Domestic politics, too, will play a critical role in Japanese and U.S. relations with the troubled administration of Corazon Aquino.

Overview

Traditionally the United States has provided military support for the Philippines, while Japan has provided economic assistance, although both have economic as well as security interests there. This intertwined support tends to benefit the interests of both Japan and the United States as well as the host country, which plays a pivotal role in U.S. defense policy and, by extension, in U.S.-Japan security relations.

Although eased U.S.-Soviet relations have lessened the perceived threat of a major conflict in the Asian Pacific region, both Tokyo and Washington emphasize the continuing importance of the 1960 U.S.-Japan Mutual Security Treaty for regional stability. Vice Foreign Minister Takakazu Kuriyama recently described the treaty as the "crucial pillar" for a continued American presence in Asia and the Pacific. U.S. Ambassador to Japan Michael Armacost also has stressed the importance of the U.S.-Japan security link for maintaining peace in a region where the activities of countries such as North Korea, Cambodia, the Soviet Union and China pose a question mark.

One of the most troubled spots is the Philippines, where a foreign debt of $26.6 billion and a 1990 budget deficit estimated at between $869 million and $1.7 billion strain a government beset by internal political turmoil and debilitating social conditions. While poverty has eased since the economic crisis accompanying the final years of Ferdinand Marcos' presidency, nearly half of the population still lives below the poverty line and harsh disparities between rich and poor have not diminished. Furthermore, bureaucratic inertia and poor infrastructure are hampering the country's ability to utilize the foreign aid and investment that could address these problems.

Relations in a Regional Context

Secretary of State James Baker reflected the importance the United States attaches to remaining a Pacific power in his June 1989 endorsement of an economic cooperation group for the Asia Pacific (see JEI Report No. 26B, July 7, 1989). Washington's objectives for the organization are to: demonstrate U.S. commitment to the region, "accompany" Japanese influence in Asia and the Pacific, secure allies in the push to open Japanese markets and create a counterweight to the European Community that could help open markets in Europe. In addition to supporting the Asian Pacific Economic Cooperation group, the United States, Japan and the Philippines also participate in private-sector initiatives aimed at promoting regional economic development, such as the Pacific Economic Cooperation Council and the Pacific Basin Economic Council.

While the basic elements of the Bush administration's Asian policy may not stray much from those emphasized by earlier administrations, political analysts have noted that the comprehensive nature of Mr. Baker's "new Pacific partnership" may reflect Washington's willingness to adapt its Asian Pacific policy to the political and economic changes that have occurred in the region in recent years. In addition to recognizing the need for increased coordination of American and Japanese policies, Mr. Baker encouraged Japan to assume a "broader international role with increased responsibility."[1] Ambassador Armacost further emphasized this tandem approach, saying, "The U.S. is expected to take the diplomatic lead in resolving regional and transnational problems, and Japan is an active partner in those endeavors."[2]

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[1] Robert Pear, "U.S. Urges Japan to Assume Wider Global Responsibility," The New York Times, June 27, 1989, p. D1.

[2] "Cooperation Needed for Security, Armacost Says," The Japan Times, June 28, 1990, p. 3.

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Vice Foreign Minister Kuriyama has noted that the military check on Tokyo inherent in the U.S.-Japan security treaty facilitates the "acceptance of a larger political and economic role for Japan by its neighbors."[3] Reflecting a sensitivity to Japan's World War II occupation of the Philippines, some Japanese diplomats have said the impetus for Tokyo to take an increased political role in the Philippines should come from Manila, not Washington or Tokyo. They add, however, that there appears to be growing acceptance in the region for an increased leadership role for Japan.

American officials seem careful to limit their vision of an increased international role for Japan primarily to an economic role, with security and political responsibilities playing minor, if any, parts. While Capitol Hill long has pushed Japan to fulfill its international obligations, including military burdensharing, the most often recommended vehicle has been an increased percentage of gross national product provided as foreign aid.

In a recent speech urging Japan and other East Asian nations to contribute more to burdensharing, U.S. Ambassador to the Philippines Nicholas Platt noted that he did not see an enhanced regional security role for Japan, "but I certainly envisage cooperation" in promoting economic development in the area.[4] A staff member of the House Foreign Affairs Committee notes that demands for greater Japanese burdensharing voiced as recently as last year have mellowed as the United States considers reductions in its own overseas forces. Political analysts contend that an increased Japanese profile in the region could include providing Asian economies with technology and helping to spur their economic growth so they are better able to absorb imports from both Japan and the United States.

Japan's neighbors recognize, if only implicitly, that its significant economic presence in the region inevitably will lead to a greater political role. Alex Magno, a political commentator for the Manila Chronicle, noted, "Among the younger generation of Southeast Asians and Filipinos, we look at the long-term trend and see that we will have to eventually form a closer network of relationships, with Japan becoming the leader."[5] Nations in the region must join Japan in order to balance emerging trading blocs in other regions, Mr. Magno said.

Responses to a greater security role for Japan in the Asia Pacific area appear to be mixed. Hadi Soesastro, executive director of Indonesia's Center for Strategic and International Studies, has said, "Our view toward Japan has changed. We're no longer that threatened . . . and we think it is legitimate for Japan as a large power to have a role in the political and security affairs of the region."[6] Yet many nations, remembering the experience of Japanese occupation during World War II, are wary of increased Japanese military spending.

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[3] Charles Smith, "Security Blanket," Far Eastern Economic Review, July 5, 1990, p. 12.

[4] "U.S. Wants More Help in East Asia," The Japan Times, May 19, 1990, p. 2.

[5] Cited in Rahti Rahil Dollahi, "Asean more receptive to political role for Japan," Japan Times, July 11, 1990, p. 3.

[6] Ibid., p. 3.

Most still feel it is important that Japanese military power be balanced by the presence of U.S. forces in the region. Thus, the potential U.S. withdrawal from bases in the Philippines or a perceived lessening of the American military commitment to the region are serious concerns for these nations. Others sense that, regardless of the U.S. military involvement, a greater Japanese economic presence will lead to a bigger political role for Tokyo.

Background of Japanese and American Involvement in the Philippines

The Philippines' still very bitter memories of Japanese occupation during World War II have tempered Tokyo's approach to that country, particularly in the security areas. Manila has voiced its concerns over Tokyo's commitment to defend the sea-lanes 1,000 nautical miles east and south of Japan -- a mission that brings the Self-Defense Forces within 200 nautical miles of Philippine shores. And suggestions by the Reagan administration that Japan share the costs of maintaining U.S. bases in the Philippines met with reservations in Manila as well as Tokyo.

Japan's vigorous economic expansion in Southeast Asia during the last three decades has had less apparent impact on the Philippines than on most of its neighbors. Trade with the Philippines expanded over this period along with direct investment, but Japanese business activities there took a back seat to what the private sector was doing in other countries in the region. Since Corazon Aquino became president in 1986, however, the Japanese government as well as the business community have increased their involvement in the Philippines. Paralleling Washington's efforts to bolster the new government, Tokyo has focused its policies on helping President Aquino stabilize the country's economy. Tokyo continuously has voiced strong support for the Aquino government, but, given a somewhat rocky relationship as well as regional sensitivities, it seems unlikely that Japan-Philippine relations will expand beyond the economic area.

Although the Philippines is America's oldest Pacific ally, the relationship has had its share of challenges. Early American involvement in the Philippines was fairly tenuous. Although the United States seized the Philippines in a move to gain the upper hand in the Spanish-American War, U.S. military installations established there were inadequate to counter any possible threat in the Pacific. Nor did the United States gain great economic benefits from its early presence in the Philippines. Historians suggest that America held onto the Philippines until it grew clear that colonial rule had not brought about the strategic and economic rewards Washington had envisioned.

In the 44 years since the country became independent, the Philippines has struggled to find its own identity. Some American observers believe that this struggle is partly behind the friction surrounding the recent talks to continue a U.S. presence at Clark Air Base, Subic Bay Naval Base and several smaller facilities in the Philippines. Shortly after the Philippines gained independence in 1946, the United States forged tight defense ties, including a mutual security treaty. But, with few exceptions, Philippine affairs have been low on the U.S. agenda until recent years.

In the early 1980s two events forced the United States to focus on the Philippines. The August 1983 assassination of Benigno Aquino, the leading opponent to the rule of then President Marcos, led the United States to take a more critical view of the Marcos government. At the same time Washington recognized the growing threat to stability posed by the Communist Party of the Philippines and its military arm, the New People's Army. The insurgency, fueled by the Philippines' serious economic troubles, underscored the fact that President Marcos had not initiated the reforms necessary to check the movement. When Mr. Marcos' obvious attempts to win the February 1986 presidential election drew serious claims of fraud and a ground swell of support appeared for Mr. Aquino's widow, Corazon, U.S. policymakers hurriedly recognized that Mr. Marcos had become more of a liability than an asset. By backing Mrs. Aquino's administration, the United States took on greater responsibility for assisting the Philippines in its attempts to restore democracy.

Military Bases Agreement

Clark Air Force Base and Subic Bay Naval Base are the only large American military installations in the Pacific south of Japan and west of Hawaii. Among the most important offshore U.S. installations, the bases provide support for American military forces stretching from the Persian Gulf to Japan and Korea. They also are considered important to the security of sea and air lanes in the region. For the Philippines the bases have meant jobs for more than 70,000 Filipinos and a reported $1 billion a year in local expenditures. The presence of the U.S. bases also boosts foreign investors' confidence in the safety of establishing an enterprise in the country.

Originally leased under a 1947 agreement, the bases remain a symbol for many in the Philippines of U.S. domination. Extensive modifications in 1966 and 1977 as well as numerous minor revisions have resulted in base arrangements similar to what the United States has with many other allies, according to one American diplomatic source. But even with these amendments and U.S. accommodations that indicate the value past administrations have placed on the role of the Philippine bases in U.S. defense policy, their presence still rankles Manila's notion of sovereignty. The sensitivity of the base arrangements intensified during last December's coup attempt against Mrs. Aquino when President Bush responded to her requests for assistance by allowing Philippine-based U.S. military aircraft to intimidate rebel aircraft.

After lengthy negotiations the United States and the Philippines agreed in October 1988 to the terms governing the last phase of the 1947 base agreement, scheduled to expire in 1991. Most of the contention centered on the annual U.S. compensation package, which, at $481 million, was far short of the $1.2 billion originally requested by Manila. Debate over the amount of compensation resurfaced in May 1990 when the two countries met for exploratory talks on the future of the bases. The Aquino administration criticized what it viewed as a $222 million shortfall in U.S. aid allocated to the Philippines in FY 1990; it formally announced the termination of the current agreement as of September 1991. American officials only concede a $96 million shortfall (which they attribute to a congressional cut) and express frustration with Manila's emphasis on compensation.

Although U.S. officials state they would prefer to maintain the bases, Washington clearly is not willing or able to pay any cost. Policymakers have warned that negotiations will fail if Manila continues to raise the compensation issue. Mr. Bush announced during the talks, "If we're not wanted there, we're not going to be there." The president claims that the bases are no longer essential and that alternatives are being examined.

Adding tension to the talks is an apparently growing disillusionment with the Aquino administration among some on Capitol Hill. Moreover, the U.S. budget deficit is forcing legislators to look at aid to the Philippines with a more critical eye. Rep. David Obey (D, Wis.), in his role as chairman of the foreign operations subcommittee of the House Appropriations Committee, has voiced considerable skepticism about Manila's ability to utilize foreign aid. This concern has not yet reached critical levels in Congress. In June Rep. Obey's panel imposed limits on military aid to three countries that host U.S. bases, yet left uncut the administration's request for normal military and economic aid for the Philippines.

The Philippine Senate, which must ratify any new base agreement, appears to be easing its former antagonism to the bases, although as of July at least 15 of the 23 senators were on record as opposing renewal. Surveys conducted among Filipinos after the May talks showed that 79 percent of the respondents agreed that a termination notice should be served, although other public opinion polls indicate that a plurality favor a renewal of U.S. base rights with, perhaps, different conditions. The situation is complicated by uncertainty and divisiveness within the Aquino administration over the direction and the purpose of future talks. It appears, however, that Filipino policymakers have grown increasingly cognizant of the geopolitical context of the base decision as well as the serious domestic economic implications of a U.S. withdrawal.

The United States must balance the Philippine demands with the cost of relocating the bases. A 1988 congressional report concluded that it would be less expensive to move the bases than to pay the "unreasonable costs" being demanded by some in Manila. U.S. assertions that the Philippine bases are not irreplaceable may be partly a bargaining ploy, but dispersing the forces currently based there would require a significant transition period and would be extremely expensive. A recent Library of Congress study estimated that the cost of new facilities, the operational expenses involved and the required increased levels of mobile naval and air forces would amount to tens of billions of dollars.[7] Furthermore, the U.S. military presence in the Philippines gives America an important economic presence in the vibrant Pacific Rim, although suggestions that Singapore partly fill the breach would help maintain U.S. visibility in the region.

The implications of withdrawing American forces from the Philippines go beyond the costs to the United States. Washington obviously is aware of the signals such a withdrawal would send internationally, although given the current disarmament climate in Europe the signal may be muted. State Department officials stress that the United States will remain committed to the region even if its forces must be dispersed. In recent reports that the Bush administration and the government of Singapore were close to completing a military basing deal, a U.S. official noted that although access to facilities in Singapore did not constitute a permanent presence "it shows that we are still engaged in Asia."[8]

[7] Larry A. Niksch, "Philippines Under Aquino," Congressional Research Service Issue Brief, July 3, 1990, p. 3.

[8] Patrick E. Tyler, "U.S. Near Agreement to Base Aircraft, Ships in Singapore," Washington Post, July 6, 1990, p. A26.

Withdrawal from the Philippines would have particularly important implications for Japan. In an article in the Japan Economic Journal that appeared shortly after this spring's exploratory talks, U.S. chief negotiator Richard Armitage wrote, "Our handling of the facilities in the Philippines must be carefully coordinated with the government of Japan so that no damage ensues to our larger interests and need for forward deployments."[9] One proposed alternative to the bases in the Philippines is to increase reliance on U.S. bases in Japan.

The Foreign Ministry's Kuriyama says Japanese officials are concerned that a withdrawal of U.S. forces from both the Philippines and South Korea could result in U.S. influence in the region being "greatly curtailed, not only militarily but also politically and economically."[10] Some Japanese observers feel that a U.S. withdrawal from the Philippines could leave a vacuum in the region that neither China nor India can fill and that Japan is politically constrained from countering. They fear that the region could become more vulnerable to Soviet political influence and that Japanese and other foreign investments in the region would be left inadequately protected.

Internal Threats

The current volatility of the Philippines' domestic situation poses a variety of pitfalls to American and Japanese interests. President Aquino faces a slew of problems, including dissent within her own administration. She recently formed a nonpartisan political movement intended to recapture the popular support that swept her into power in 1986. One goal of the Kabisig (Linking Arms) Movement is to push through projects caught in a bureaucratic snarl and speed up the delivery of basic services. The initiative appears to reflect Mrs. Aquino's frustration with her country's entrenched political system; however, congressmen apparently have interpreted it as a direct attack.

A more immediate threat to her survival comes from the significant discontent in the army. President Aquino has survived several coup attempts led by members of the Philippine armed forces. Among their dissatisfactions are disagreement with the military power structure, disputes over President Aquino's policies toward the communist insurgency and frustration with the country's political structure and social conditions. Last December's coup attempt was coordinated by the Reform of Armed Forces Movement, a group formed in the early 1980s by an officer corps dedicated to bringing professionalism back to the military. Apparently helping RAM in the unsuccessful overthrow was the Young Officers Union, a new reform group in the military that is gaining influence quickly.

The communist insurgency led by the New People's Army, the military arm of the Communist Party of the Philippines, continues to pose a threat to the Aquino government, although official estimates show a decline in NPA forces since a 1986 peak. In some respects the rebels have become as much of a problem for Americans and Japanese working in the Philippines as for the government. The New People's Army has been linked to most of the 10 assassinations of

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[9] Richard L. Armitage, "Security comes first as Asia enters world stage," Japan Economic Journal, May 26, 1990, p. 9.

[10] Smith, op. cit., p. 11.

Americans that have occurred since 1987. Philippine Communist Party statements have indicated that the insurgents are targeting American government personnel -- civilian as well as military -- and aid workers. The NPA claimed responsibility for killing two American airmen outside Clark Air Base before the May base talks and shortly afterward issued a statement warning that U.S. bases and American military personnel were targets for future attacks.

Tokyo's participation in the multilateral economic assistance program for the Philippines and the perceived anti-insurgent objectives of its aid programs have made Japan a leftist target, too. In 1989 the Philippine military revealed a letter reportedly written by the exiled founder of the Communist Party of the Philippines, who recommended warning Japan "against joining a U.S.-sponsored plan to buy off the U.S. bases' retention." Jose Maria Sison purportedly wrote the letter to a rebel colleague in 1988 and proposed cautioning Japan that any "improper" policy toward the Philippines would harm its interests there.

In recent months communist rebels have issued warnings that they would attack foreign-assisted projects that abet the government's anti-insurgency policy. In late May a private Japanese aid worker was kidnapped by suspected communist rebels. According to a Philippine military official, the rebels apparently believed the kidnap victim's sponsor -- the Organization for Industrial, Spiritual and Cultural Advancement -- is part of a campaign to weaken communist influence in rural areas through socio-economic projects.

In late June the United States announced its decision to pull Peace Corps volunteers out of the Philippines, apparently in response to information that the NPA had expanded its terrorist strategy to include them. Shortly afterward it was discovered that a Peace Corp volunteer had been abducted earlier in the month. The Japan International Cooperation Agency, which handles the technical assistance part of Japan's aid program, reportedly has urged the Japan Overseas Cooperation Volunteers, a Japanese version of the Peace Corps, to be particularly careful. An agency official has warned that the kidnapping of a JOCV volunteer would have a serious impact on Japan's aid program in the Philippines, although the agency apparently has no plans to withdraw. JICA reports indicate that approximately 75 JOCV volunteers were working in the Philippines in late 1989, mostly on agriculture, forestry and fishing projects. A rebel spokesman said the two American and the Japanese were kidnapped because they were viewed as assisting in the government's anti-insurgency plot.

In May a rash of bomb threats, bombings and assassinations in Manila led the government to deploy thousands of troops in the capital. The activities were attributed to suspected left-wing and right-wing rebels. The Japanese Embassy in Manila reportedly received several bomb threats this past spring. Philippine newspapers reported that Manila recently initiated investigations into the kidnappings of two other Japanese nationals and the murder of a Japanese businessman.

U.S. and Japanese Foreign Aid to the Philippines

Political discontent in the Philippines obviously is fueled by the country's economic struggles. In some respects the Philippine economy has made advances under President Aquino, particularly in light of the economic shambles left by Mr. Marcos. The economy's real growth rate over the last three years has been 5 to 6 percent. The Aquino administration has been commended for not allowing inflation to run out of control, though it is a serious problem. In June inflation was 12.2 percent, down slightly from the previous month, but up almost 3 percentage points from the same time last year.

Furthermore, the Aquino administration's record of managing the country's foreign debt, which is pegged at $26.6 billion by the government, is respectable, and Manila recently has initiated a Brady Plan-type of debt reduction to tackle the problem (see below). Yet whether the Philippines' creditors will continue to pump money into the economy will depend on President Aquino's ability to deliver the promised economic reforms. The International Monetary Fund has expressed serious concerns about the Philippines' budget deficit, and future IMF credit disbursements are on hold pending a review of Manila's economic performance.

In early July President Aquino approved a 1991 national government budget totaling $10.7 billion. Approximately one-third of the budget, $3.3 billion, is earmarked for debt service, up from this year's figure of $2.7 billion. Acknowledging the strict economic reform guidelines from the IMF and other international lending bodies, Philippine Finance Secretary Jesus Estanislao has said the government would rely on increased tax collection efforts to narrow a budget deficit threatening to reach $2.8 billion in 1990. But the government also clearly is counting on bilateral and multilateral loans and foreign debt relief. Manila has indicated that it will lean more heavily on foreign sources to finance development projects in 1991.

The Philippines' budget problems have frustrated opportunities for economic growth -- the source of greater internal revenues -- partly because resources are not being directed effectively to much needed projects, such as infrastructure improvements. A prime example is the country's power shortage. Recent estimates indicate that brownouts alone may reduce economic growth by 1.1 percentage points this year. The earthquake that struck near Manila in July certainly will mean further setbacks for the country's growth.

The Philippines' economic troubles are most immediate for the 49 percent of the population that lives below the poverty line. In 1987 per capita gross national product was $546. Income maldistribution is severe; according to 1988 data, the top 20 percent of the population controlled more than 50 percent of the country's total income.

Multilateral Assistance Initiative - Both Tokyo and Washington have substantial foreign aid programs aimed at stabilizing the Philippines' shaky economic and political situation. Each government showed support for the new Aquino government with significant increases in aid. In late 1987 U.S. legislators urged the Reagan administration to initiate a multilateral economic assistance program -- dubbed the mini-Marshall Plan -- that would help the Philippines get back on its feet. After several months of negotiations 19 countries and seven international organizations pledged in July 1989 a total of $3.5 billion for the 1989-90 period. The program is expected to infuse the Philippine economy with $10 billion over five years, much of it through increased private investment and reduction of the country's official foreign debt.

The Multilateral Assistance Initiative is coordinated by the World Bank and serves as an umbrella under which the Philippines' major donor countries have committed considerably expanded development assistance. Japan promised the largest amount, $1.6 billion for the 1989-1990 period. The figure includes $600 million in debt-reduction assistance, part of which represents the Export-Import Bank of Japan's previous commitment to parallel International Monetary Fund lending to the Philippines. Japan's MAI contribution represents an increase of about $300 million over its 1989 Philippine aid outlays. The United States pledged $1 billion over the life of the MAI project; the Bush administration requested $200 million in funding for 1990, but Congress appropriated only $160 million. Some of the U.S. contribution to the plan incorporates aid promised under the October 1988 base agreement.

Japanese officials have been insistent that the MAI package be free of military or political ties, particularly the issue of U.S. base rights. While Washington certainly does not deny that successful implementation of MAI will create a more favorable climate for the base talks, American officials have downplayed the military and the political implications of the program. Referring to the Philippine Assistance Program, which is how MAI is known in the Philippines, Ambassador Platt has argued, "You cannot negotiate for bilateral basing rights on other people's money and the PAP is mostly other people's money."[11]

MAI's purpose is to provide the Philippines with a firmer economic base -- one that will encourage private investment and, in turn, promote economic growth and democracy. The Philippine government has targeted five regions in the country for infrastructure developments that are intended to attract private investment in job- and income-creating enterprises. Beyond improving the country's infrastructure, the MAI package is intended to encourage economic policy reforms, particularly relaxation of regulations and privatization of public enterprises. Manila has established a coordinating council for PAP as well as a Committee on Official Development Assistance, which will coordinate all development assistance. It is hoped that these two organizations will focus funds on appropriate development needs as well as enable more effective absorption of the aid, long a problem for Manila.

Throughout the development of MAI, donors expressed concern over Manila's poor record in utilizing foreign aid in a timely and effective manner; they urged reforms aimed at pushing projects through the pipeline. In announcing Japan's MAI contribution, Tokyo emphasized the importance it placed on improvements in Manila's implementation capacity and noted that the future success of the plan would depend on advances in this area. Yet Philippine press reports indicate slow progress. The Philippine Congress reportedly hindered implementation of MAI by taking several months to adopt guidelines. Furthermore, projects proposed under MAI have been held up by lack of coordination between government agencies.

The MAI pledging session for 1991 will take place later this year, and U.S. officials expect that, with the basic elements in place, phase two will be more routine. Despite continued concerns about clogs in the pipeline, the principal MAI donors are unlikely to reduce their levels of support, according to Elliot Richardson, U.S. special MAI representative. The Bush administration requested $200 million as its second contribution, but the House has approved

[11] "Communist Rebels to Warn Japan Not to Support Aid Plan," Kyodo News Service, August 11, 1989.

only $160 million, the same amount appropriated for this year. It remains to be seen how much the Senate -- which is considering $1 billion less for overall FY 1991 foreign aid -- will vote. Tokyo's suspected unhappiness with Manila's implementation of a development strategy has prompted rumors in the Philippines that Japan had declined to be the next pledging session host. But American and Japanese officials say only that the site has not been determined. The Foreign Ministry continues to express support for MAI. The Philippines' finance secretary has said that donor countries, including the United States and Japan, have promised not to scale down their MAI commitments.

Meanwhile, Philippine press reports complain that the only significant expenditure of MAI funds to date has been debt alleviation. In February MAI funds provided most of the money for a buy-back operation, which retired $1.3 billion worth of foreign debt (see below). Tokyo recently announced, however, that it had pledged loans for a project intended to boost the agro-industrial development of the Negros and the Panay Islands. Japan's contribution includes cofinancing with international banks. Several donor nations and international organizations reportedly have committed funding for the project.

Bilateral Aid Programs - In addition to its MAI contribution the United States provides substantial foreign aid linked to its base rights in the Philippines. In the October 1988 base agreement the Reagan administration pledged its "best efforts" to secure $481 million of aid for the FY 1990-FY 1991 period. Capitol Hill cut base-related aid for FY 1990 by $96 million, a "shortfall" decried by Philippine negotiators, but with special funds pledged under MAI total FY 1990 aid authorized for the Philippines could reach $545 million.

The American aid program for the Philippines includes economic support funds, a special category of economic assistance for countries with particular economic, political or military significance to the United States. In contrast to development aid -- which is aimed at achieving long-term development objectives -- economic support funds focus on short-term economic stabilization and budget concerns.

Despite the growing geographical diversification of Japan's rapidly expanding assistance program, Asia still receives more than 60 percent of its foreign aid. Part of the explanation is that Tokyo has increased its aid to areas with strategic significance in recognition of the importance of supporting economic stability in such countries and, in some respects, in line with its burdensharing initiatives. Many of these countries are in Asia. Thus, the Philippines long has been among the top recipients of Japan's foreign aid; in 1987 and 1988 it was the third-largest recipient. Furthermore, Japan is the largest source of aid for the Philippines. In 1987 Japan provided 53.7 percent of the total foreign aid allotted to the Philippines by members of the Development Assistance Committee of the Organization for Economic Cooperation and Development.

According to the Ministry of Foreign Affairs, Japanese loans and grants in 1988 supported such projects as infrastructure development, teacher training and disaster assistance. In addition, approximately $1.8 million went to debt relief. Although some Japanese aid projects have been criticized as environmentally insensitive, Japanese aid officials have said that recently adopted environmental guidelines will steer Japanese aid away from projects suspected of causing pollution.

Loans have comprised the overwhelming portion of Japan's official development assistance to the Philippines in recent years, a trend that may change as Japan boosts its efforts to increase the grant element of its ODA. Last year the Overseas Economic Cooperation Fund, the soft loan arm of Japan's foreign aid program, committed to a $750 million loan package to the Philippines. This year the Philippines has requested a yen loan package worth $1.9 billion. The funds are to be used on such high-priority projects as flood control, rural electrification, irrigation and transportation.

OECF also plans to provide most of the $358 million the Philippines will receive as its share of a $2 billion loan package aimed at helping members of the Association of Southeast Asian Nations develop their industrial bases. Former Prime Minister Noboru Takeshita unveiled the Asean-Japan Development Fund in 1987; it is part of Japan's effort to recycle $20 billion of its current account surplus to the Third World through aid. The Philippines will receive about $275 million in loans from OECF, with the remainder coming from the Export-Import Bank of Japan.

Complementing official development assistance, Japan also provides credits to the Philippines through Ex-Im. In May the bank agreed to make a $300 million loan to the Philippine government to finance the import of goods and services. The credit reportedly will be extended in parallel with a financial-sector adjustment loan from the World Bank. The first tranche of Japanese funds is expected to be offered in August; the release of the remaining funds will hinge on whether the Philippine government carries out banking reforms sought by the World Bank and the Ex-Im Bank.

In August 1989 the Philippines became the second country to take advantage of a new debt initiative introduced earlier in the year by Treasury Secretary Nicholas Brady (see JEI Report No. 33B, August 25, 1989). The negotiations between Manila and its international lenders held special interest for Tokyo since, by most accounts, Japanese banks have more money at stake in the Philippines than American banks.

The Aquino government, hoping to attract new funds to finance economic growth, strayed slightly from the original concept of the Brady Plan by opting for an accord that emphasizes fresh loans over debt reduction. The plan combines $1 to $1.2 billion of new lending at favorable rates, cash buy-backs of loans at rates to be determined relative to market rates and a 0.0625 percentage-point reduction in interest rates on much of the existing debt. Treasury officials have pointed out that the fresh-loan emphasis of the agreement is well-suited to the Philippines because most of its debt is owed to governments and international lending institutions, which generally do not agree to loan write-downs. The debt buy-back element included in the financing plan, along with several other debt-reduction schemes and currency adjustments, have enabled the Philippines to reduce its external debt by nearly $1.5 billion since last December.

Although some parts of the international financial community have called for a greater emphasis on debt relief in the hopes of getting around Manila's troublesome flow of funding, many believe such a policy would create a dangerous precedent. According to an OECF representative, Japan is unlikely to shift its focus to debt relief rather than development assistance for the Philippines.

In early July the Philippines and the International Monetary Fund reached an agreement on a revised economic program that will scale down the country's 1990 real GNP growth target to between 4.8 and 5.2 percent. The Philippines agreed to target a higher rate last year in return for a three-year IMF credit worth nearly $1.2 billion. The IMF executive board is expected to review the program later this summer and decide whether the Philippines has undertaken sufficient economic reforms to merit the release of the third year of funding. If IMF approval is withheld it will have serious consequences; foreign government and commercial bank creditors will balk at making further deals with Manila, according to American and Japanese aid officials. The revised economic program includes proposals to cut tariffs and otherwise liberalize trade, speed up privatization of government-run businesses and raise additional taxes. Manila has admitted that the reforms will boost inflation, keeping it above 13 percent for the next few months. Officials hope, however, to bring the inflation rate down to an annual rate of 9.5 percent by the end of the year.

Trade and Investment

One of Manila's economic objectives for the Philippines is to become a newly industrialized economy like South Korea, Taiwan, Hong Kong and Singapore by the 21st century. Yet the Philippines' economic expansion has lagged compared to that of other Asean members, particularly Singapore and Thailand. In 1988 President Aquino expressed concerns that the disparate economic growth of Asean countries could weaken economic and possibly political cooperation among the six member nations (Indonesia, Malaysia, Thailand, Singapore, the Philippines and Brunei). Although uneven development threatens to put the Philippines at a disadvantage in any future Asean trading bloc, the country has benefited as an investment site for its neighbors, particularly the NIEs. Hong Kong and Taiwan have been among the top investors in the Philippines in recent years; in 1989 capital from the two represented 30 percent of total corporate investment in the country.

In addition, the Philippines stands to gain from the four NIEs' December 1988 loss of Generalized System of Preference benefits for exports of selected products shipped to the United States. In 1987 the Philippines ranked last among its Asia Pacific counterparts in taking advantage of this preferential tariff treatment. This has led economic analysts to predict that some countries may shift their operations from the NIEs to the Philippines in order to fully exploit GSP benefits.

While Japan's trade with East Asia is growing rapidly, some analysts see America's economic involvement in the region as beginning to slow. IMF figures indicate that the Philippines, at least, still relies more on U.S. transactions, conducting 27.4 percent of its two-way trade in 1988 with the United States and 18.5 percent with Japan. Machinery and equipment constitute Japan's top exports to the Philippines, followed by steel and chemicals. Its primary imports from the Philippines are bananas, fish and metal ores and scrap -- a marked contrast with the list of U.S. imports, which is headed by semiconductors and clothing. Manila has pushed Japan to open its markets further in ways that would benefit Philippine products and to assist with export product development, but Japan's exports to the Philippines generally increased at a faster rate than its imports in the second half of the 1980s.

As the developers of MAI recognized, private investment is essential for continued economic growth in the Philippines. Yet it is not clear whether the opportunities for investment in the Philippines outweigh the risks and frustrations. Investors cite the Philippines' strategic location, a large, well-trained English-speaking labor force and a fairly substantial domestic market as incentives for investment. Yet according to Mark Blacker, president of the American Chamber of Commerce in the Philippines, some foreign investors are being driven away from the Philippines by inadequate infrastructure (including electricity), discriminatory legislation, security threats and bureacratic inertia. Among the most frustrating regulations for offshore investors are rules limiting foreign ownership of a company to 40 percent and leases to a maximum of 25 years. Investors have appealed to the government to revise the regulations, but so far Philippine legislators have done little but promise change. The Philippine investment climate particularly pales in comparison to that of its Southeast Asian neighbors.

Foreign investment registered with the Central Bank of the Philippines in the first quarter of 1990 was 62 percent higher than in the January-March 1989 period -- $47.9 million compared to $29.5 million. Yet foreign investors withdrew $98 million from the Philippines between January and April 1990, a sharp contrast to total 1989 withdrawals of $95 million. Although Philippine bank sources blame the investment flight to nervousness following the December 1989 coup attempt, many observers believe that legal and logistical hassles are more to blame for foreign investors' cold feet than political threats.

While American businesses that have been in the Philippines for decades appear to be doing well, U.S. investors have directed little new money into the country in recent years. In 1989 the United States slipped from being the biggest investor there to the third largest. On the positive side two American companies -- Bechtel Group and American Express Co. -- have joined a consortium that plans to develop a light industry and science park south of Manila. John Callebaut, director of the Washington-based U.S.-Philippine Business Committee, notes that the type of development projects encompassed under MAI "are certainly the type where U.S. companies are competitive in terms of supplying equipment and services." However, several American corporations have relocated to nearby countries. In July Caltex Corp. pulled out of a $340 million power plant project on which it had spent two and a half years negotiating and Ford Motor Co. canceled plans to build a $150 million automotive audio equipment plant.

Japanese direct investment in the Philippines has increased rapidly in recent years. According to the Philippines Department of Trade and Industry, Japan eclipsed the United States and Taiwan and became the biggest investor in the country in 1989. Japan's ambassador to the Philippines recently described Japanese investors as "still positive but cautious." Most Japanese investment has gone into the manufacturing sector; investments there represented more than 82 percent of the 1989 total, followed by 8.8 percent in the service sector, according to Philippine sources. As of March 1989 an estimated 130 Japanese firms were operating in the Philippines through link ups such as joint ventures. Two electronics manufacturers were among the largest Japanese investors at the time -- Uniden Corp. and Matsushita Electric Industrial Co., Ltd.

The Philippines also was the first client of the Japan International Development Organization -- established by Keidanren (Japan Federation of Economic Organizations) in 1989 to encourage private-sector involvement in Third

World development. The business group's decision to make the Philippines its test case reportedly was spurred by Japanese investors' complaints about the difficulties of investing there. A JAIDO mission to the Philippines in May 1989 netted four major investments, but as an indication of the difficulties some foreign investors face in the Philippines, two industrial parks involving Japanese investors have been bogged down by interdepartmental land-use disputes.

As the Philippines tries to shift to products that will supply more added value, its imports have climbed, rising 27 percent in the first quarter of 1990, for example. Analysts note that this jump was partly due to an increase in purchases of power-generating equipment and other capital goods, but imports of consumer goods also rose sharply in the period. Philippine exports grew too, by 9 percent, which included rises in its leading exports, electronic goods and clothing. But analysts see power shortages and rising production costs as imperiling the country's manufacturing sector, while slumping world prices for the Philippines' agricultural and mineral products could boost its trade deficit.

Outlook

In many ways the upcoming months will be a critical period for the Philippines. Washington's uneasiness with the political and economic situations in the country appears to be growing. According to one congressional staff member, "President Aquino's halo has somewhat vanished." Internationally many believe the chance of another coup attempt is very high. Much will depend on the outcome of base negotiations covering the post-1991 period to be held later this year. Japanese and American policymakers and investors considering their potential involvement in the Philippines will be weighing both the results of the talks and Manila's success in carrying out crucial economic reforms.

For further information, contact Margo Grimm.

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The views expressed in this report are those of the author and do not necessarily represent those of the Japan Economic Institute.

APPENDIX

Table 1: Japan's Exports to Noncommunist Asian Countries, 1985-89

(in millions of dollars, f.o.b. value basis)

	1985	1986	1987	1988	1989
South Korea	$7,097	$10,475	$13,229	$15,441	$16,561
Taiwan	5,026	7,852	11,346	14,354	15,421
Hong Kong	6,509	7,161	8,872	11,706	11,526
Singapore	3,861	4,577	6,008	8,311	9,239
Thailand	2,030	2,030	2,953	5,162	6,838
Malaysia	2,168	1,708	2,168	3,060	4,124
Indonesia	2,173	2,662	2,990	3,054	3,301
Philippines	937	1,088	1,415	1,740	2,381
India	1,596	2,099	1,957	2,082	2,018
Noncommunist Asia Total	33,248	41,788	52,982	67,109	73,516
Total Exports	175,638	209,151	229,221	264,917	275,175

Source: Japan Tariff Association

Table 2: Japan's Imports from Noncommunist Asian Countries, 1985-89

(in millions of dollars, c.i.f. value basis)

	1985	1986	1987	1988	1989
South Korea	$4,092	$5,292	$8,076	$11,811	$12,994
Taiwan	3,386	4,691	7,128	8,744	8,979
Hong Kong	767	1,074	1,561	2,109	2,219
Singapore	1,594	1,463	2,048	2,339	2,952
Thailand	1,027	1,391	1,796	2,751	3,583
Malaysia	4,330	3,846	4,772	4,710	5,107
Indonesia	10,119	7,311	8,427	9,497	11,021
Philippines	1,243	1,221	1,353	2,044	2,059
India	1,189	1,297	1,530	1,804	1,978
Noncommunist Asia Total	30,264	29,489	38,627	47,802	52,906
Total Imports	129,539	126,408	149,515	187,354	210,847

Source: Japan Tariff Association

Table 3: U.S. Exports to Noncommunist Asian Countries, 1985-89*

(in millions of dollars, f.a.s. value basis)

	1985	1986	1987	1988	1989
South Korea	$5,956	$6,355	$8,099	$11,290	$13,478
Taiwan	4,700	5,524	7,413	12,131	11,323
Singapore	3,476	3,380	4,053	5,770	7,353
Hong Kong	2,786	3,030	3,983	5,691	6,304
Malaysia	1,539	1,730	1,897	2,139	2,875
India	1,642	1,536	1,463	2,498	2,463
Thailand	849	936	1,544	1,964	2,292
Philippines	1,379	1,363	1,599	1,880	2,206
Indonesia	795	946	767	1,056	1,256
Noncommunist Asia Total	24,529	26,099	31,985	46,061	n.a.
Total Exports	218,828	227,159	254,122	322,426	364,350

*Excludes Japan.

Source: Department of Commerce

Table 4: U.S. Imports from Noncommunist Asian Countries, 1985-89*

(in millions of dollars, c.i.f. value basis)

	1985	1986	1987	1988	1989
South Korea	$10,713	$13,497	$17,991	$21,209	$20,593
Taiwan	17,761	21,252	26,407	26,256	25,628
Singapore	4,412	4,884	6,395	8,226	9,183
Hong Kong	8,994	9,474	10,490	10,810	10,238
Malaysia	2,399	2,534	3,053	3,853	4,927
India	2,478	2,465	2,725	3,167	3,551
Thailand	1,543	1,873	2,387	3,424	4,635
Philippines	2,334	2,150	2,481	2,906	3,308
Indonesia	4,933	3,675	3,719	3,494	3,874
Noncommunist Asia Total	56,861	63,375	77,608	85,438	n.a.
Total Imports	361,626	387,082	424,082	459,542	492,870

*Excludes Japan.

Source: Department of Commerce

Table 5: Japan's Direct Investment Position in Asia, Yearend FY 1985-FY 1989

(in millions of dollars; gross value; notification basis)

	FY 1985	FY 1986	FY 1987	FY 1988	FY 1989
Indonesia	$8,423	$8,673	$9,218	$9,804	$10,435
Hong Kong	2,931	3,433	4,505	6,167	8,066
Singapore	2,269	2,571	3,065	3,812	5,715
South Korea	1,683	2,118	2,765	3,248	3,854
Thailand	760	884	1,134	1,992	3,268
Malaysia	1,125	1,283	1,446	1,834	2,507
China	287	513	1,740	2,036	2,474
Taiwan	761	1,051	1,419	1,791	2,285
Philippines	892	913	985	1,120	1,322
Asia Total	19,463	21,790	26,658	32,227	40,465
Total Investment	83,649	105,970	139,334	186,356	253,896

Source: Ministry of Finance

Table 6: U.S. Direct Investment Position in Asia, Yearend 1985-89*

(in millions of dollars, net book value basis)

	1985	1986	1987	1988	1989**
Hong Kong	$3,295	$3,912	$4,390	$5,244	$5,853
Indonesia	4,475	3,217	3,050	2,925	3,696
Singapore	1,874	2,256	2,462	2,290	2,213
Taiwan	750	869	1,280	1,622	1,949
South Korea	743	782	1,003	1,501	1,889
Philippines	1,032	1,299	1,220	1,511	1,682
Thailand	1,074	1,078	1,274	1,132	1,279
Malaysia	1,140	1,021	1,019	1,135	1,098
China	311	167	207	310	n.a.
Asia Total	15,400	15,332	16,694	18,515	20,991
Total Investment	230,250	259,800	307,983	333,501	373,436

*Excludes Japan.
**Preliminary.

Source: Department of Commerce

Table 7: Japan's Official Development Assistance to the Philippines, 1984-88*

(in millions of dollars)

	Grants			
	Grant Aid	Technical Cooperation	Loans	Total
1984	$26.4	$31.3	$102.4	$160.1
1985	39.9	29.8	170.3	240.0
1986	41.1	39.3	357.6	437.9
1987	66.9	44.9	267.6	379.4
1988	70.4	60.7	403.6	534.7

*Net disbursement basis.

Source: Ministry of Foreign Affairs

Table 8: U.S. Foreign Assistance to the Philippines, FY 1986-FY 1991

(in millions of dollars)

Fiscal Year	Loans	Grants	Total
1986	$56.3	$447.9	$504.2
1987	--	399.3	399.3
1988	--	414.5	414.5
1989	--	314.2	314.2
1990	--	504.4	504.4
1991 requested	--	647.1	647.1

Fiscal Year	Development Aid	Other Economic Aid	Food Aid	Economic Support Funds	Military Aid	Total
1986	$51.4	$4.4	$43.3	$300.0	$105.1	$504.2
1987	17.6	4.8	39.0	235.1	102.8	399.3
1988	40.0	--	57.9	189.0*	127.6	414.5
1989	46.7	--	15.9	124.0	127.6	314.2
1990	46.7	160.0**	30.9	124.0	142.7	504.4
1991 request	55.0	200.0**	32.1	160.0	200.0	647.1

*Includes an additional $50 million for agrarian reform.
**Funds for the Multilateral Assistance Initiative.

Source: Compiled by Library of Congress from Agency for International Development data.

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JAPAN · ECONOMIC · INSTITUTE

JEI REPORT

A Two-Part Report: A and B

NO. 29B
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IN THIS ISSUE:

Japan's Trade Surplus Drops Again 1

Japan Remains Top Creditor 4

Posturing Continues On Northern Territories 7

Tokyo Prepares To Resume China Aid 8

Senate Panel Considers Bill Relaxing Antitrust Laws For Joint Production 10

Notes: Drift-Net Fishing Suspension 12

Japan's Trade Surplus Drops Again

Amid the ups and downs of the exchange rate -- and the bilateral political rhetoric -- one factor in Japan's trade picture has changed little in recent years: its trade surplus keeps falling. Despite the year-and-a-half-old downward trend in the yen's value, Japan's overall trade surplus declined another 18 percent on a dollar-denominated year-to-year basis in the April-June period (see Tables). The drop was the fifth straight year-to-year quarterly decline. The slide was even steeper -- 22.8 percent -- comparing the surplus in the first half of 1990 to the same period in 1989. Furthermore, the decline was broad based. During the second quarter the surplus with the United States fell a sharp 25.7 percent in dollar terms from the April-June 1989 quarter. The worldwide and bilateral yen-denominated surplus also showed drops.

Do the figures mean that Japan's trade surplus is likely to be a thing of the past before long? Of course not. Even if the decline should continue at the same dollar amount as the annualized rate for 1990's first half, five years would be required to eradicate the surplus, which topped $64 billion in 1989. Moreover, experts disagree widely as to whether this rate of decline will be maintained.

Japan's Total Trade in Dollar Terms

(in millions of dollars)

	Exports (f.o.b.)	Change Over Year-Earlier Period	Imports (c.i.f.)	Change Over Year-Earlier Period	Trade Balance
1985	$175,638	3.2%	$129,539	-5.1%	$46,099
1986	209,151	19.1	126,408	-2.4	82,743
1987	229,221	9.6	149,515	18.3	79,706
1988	264,917	15.6	187,354	25.3	77,563
1989	275,175	3.9	210,847	12.5	64,328
1988: I	60,279	17.1	44,505	39.2	15,774
II	65,179	14.5	47,260	29.9	17,919
III	67,169	16.1	47,258	23.2	19,911
IV	72,291	14.8	48,331	12.9	23,960
1989: I	68,227	13.2	51,142	14.9	17,085
II	67,602	3.7	51,292	8.5	16,310
III	69,595	3.6	53,048	12.3	16,547
IV	69,751	-3.5	55,364	14.6	14,387
1990: I	66,718	-2.2	54,302	6.2	12,416
II (p)	67,221	-0.6	53,848	5.0	13,373

Japan's Total Trade in Yen Terms

(in billions of yen)

	Exports (f.o.b.)	Change Over Year-Earlier Period	Imports (c.i.f.)	Change Over Year-Earlier Period	Trade Balance
1985	Y41,956	4.0%	Y31,085	-3.8%	Y10,871
1986	35,290	-15.9	21,551	-30.7	13,739
1987	33,315	-5.6	21,737	0.9	11,578
1988	33,939	1.9	24,006	10.4	9,933
1989	37,823	11.4	28,979	20.7	8,844
1988: I	7,713	-3.1	5,688	14.7	2,025
II	8,163	0.1	5,918	13.6	2,246
III	8,924	4.9	6,280	11.3	2,644
IV	9,139	5.1	6,121	3.3	3,018
1989: I	8,705	12.9	6,516	14.6	2,189
II	9,222	13.0	6,997	18.2	2,225
III	9,911	11.0	7,547	20.2	2,363
IV	9,985	9.3	7,919	29.4	2,067
1990: I	9,767	12.2	7,929	21.7	1,838
II (p)	10,447	13.3	8,375	19.7	2,072

Japan's Trade with the United States in Dollar Terms

(in millions of dollars)

		Exports (f.o.b.)	Change Over Year-Earlier Period	Imports (c.i.f.)	Change Over Year-Earlier Period	Trade Balance
1985		$65,278	8.9%	$25,793	-4.0%	$39,485
1986		80,456	23.3	29,054	12.6	51,401
1987		83,580	3.9	31,491	8.4	52,090
1988		89,634	7.2	42,037	33.5	47,597
1989		93,189	4.0	48,246	14.8	44,943
1988:	I	19,859	10.3	10,090	44.4	9,769
	II	21,610	2.0	10,458	37.8	11,152
	III	23,056	6.6	10,667	29.3	12,389
	IV	25,109	10.3	10,821	25.0	14,288
1989:	I	22,726	14.4	11,599	15.0	11,127
	II	22,997	6.4	12,064	15.4	10,933
	III	24,117	4.6	12,462	16.8	11,655
	IV	23,347	-7.0	12,120	12.0	11,227
1990:	I	21,664	-4.7	12,728	9.7	8,936
	II (p)	20,950	-8.9	12,827	6.3	8,123

Japan's Trade with the United States in Yen Terms

(in billions of yen)

		Exports (f.o.b.)	Change Over Year-Earlier Period	Imports (c.i.f.)	Change Over Year-Earlier Period	Trade Balance
1985		Y15,583	9.6%	Y6,213	-2.4%	Y9,369
1986		13,564	-13.0	4,918	-20.9	8,646
1987		12,148	-10.4	4,582	-6.8	7,566
1988		11,487	-5.4	5,388	17.6	6,099
1989		12,816	11.6	6,632	23.1	6,184
1988:	I	2,541	-8.8	1,290	19.1	1,251
	II	2,706	-10.8	1,309	20.5	1,397
	III	3,063	-3.6	1,418	16.7	1,645
	IV	3,177	0.9	1,371	14.4	1,806
1989:	I	2,899	14.1	1,478	14.6	1,421
	II	3,139	16.0	1,648	25.9	1,491
	III	3,436	12.2	1,773	25.0	1,663
	IV	3,342	5.2	1,733	26.4	1,609
1990:	I	3,170	9.4	1,859	25.8	1,311
	II (p)	3,256	3.7	1,995	21.1	1,261

The pessimists, who believe that Japan's surplus is likely to prove intractable, have two main arguments. First, the current figures are somewhat distorted by the yen being weaker in this year's first six months than in January-June 1989. Adjusting for the price changes resulting from this and other factors, Japan's trade balance was virtually unchanged between the two periods. For example, using 1989 prices and yearly percentage changes in volume, Japan's real trade imbalance declined a scant 0.4 percent on a year-to-year basis in the second quarter. Second, the weak yen is unlikely to be even a mixed blessing for long. Eventually, Japanese exports will respond strongly to the exchange rate, lifting the surplus in dollar terms. This effect may be evident already, obscured by the use of year-to-year data. On a seasonally adjusted month-to-month basis, the trade imbalance in dollar terms grew in May and June.

Optimists argue that the yen's unprecedented rise between 1985 and November 1988 has not yet played itself out. Specifically, they believe that foreign direct investment by Japanese firms, motivated in part by the currency realignment during that period, has differing short- and long-run effects. The short-run impact, which has been dominant up to now, leads to higher exports from Japan in the form of capital goods to equip the foreign plants and to more parts for final assembly abroad. Together, these effects more than offset what is initially a small decline in finished goods exports. Over time, however, local content rises, reducing parts exports compared to earlier levels even if new investment remains at the same rate. In addition, final goods exports are likely to fall further, and modest shipments from the overseas plants to Japan may lift imports. Over time, this argument concludes, the net effect of foreign investment is to reduce the trade surplus.

An Economic Planning Agency study released in mid-July appears to boost the optimists' argument. EPA assumed that, if recent levels of overseas investment flows, domestic content rates and reexport percentages to Japan remain unchanged, then Japan's surplus would be $18.5 billion smaller five years from now than what it would be in the absence of such an investment flow. Simulations conducted by private organizations have found even larger effects of foreign investment on the trade surplus. EPA cautions that the actual direction of the imbalance will depend on a number of factors that are difficult to forecast. The exchange rate obviously heads this list. Changing export and import patterns arising from foreign investment are likely to affect the value of the Japanese currency. For example, if the effect of foreign investment should be to reduce net exports, then the yen could weaken, producing offsetting effects on the trade surplus. At most, EPA's exercise demonstrates one set of plausible circumstances under which a continued substantial reduction of Japan's still-large trade surplus could occur.

Douglas Ostrom

Japan Remains Top Creditor

Japan has added another economic trophy to its collection, but the latest one is a bit tarnished. For the fifth straight year Japan's overall foreign assets exceeded its offshore liabilities in 1989 by a greater margin than in any other nation, making it the world's largest creditor at yearend. However, the rate of increase in net assets came to a measly 0.5 percent (see

Table 1). Most of the creditor position is accounted for by the private sector, which was a net debtor as recently as 1981.

Table 1: Japan's Net External Assets, 1972-89

(in millions of dollars)

End of Year	Private Sector	Government Sector	Total
1972	$-6,820	$20,687	$13,867
1973	-3,021	16,037	13,016
1974	-8,318	17,261	8,943
1975	-10,302	17,320	7,018
1976	-11,653	21,227	9,574
1977	-6,182	28,162	21,980
1978	-2,550	38,764	36,214
1979	850	27,927	28,777
1980	-16,659	28,193	11,534
1981	-18,537	29,455	10,918
1982	2,046	22,636	24,682
1983	11,928	25,331	37,259
1984	47,069	27,277	74,346
1985	104,450	25,371	129,821
1986	138,541	41,810	180,351
1987	146,494	94,250	240,744
1988	147,571	144,175	291,746
1989	158,839	134,376	293,215

Source: Bank of Japan, Balance of Payments Monthly, April 1990.

Washington takes a particularly dim view of statistics on net creditor positions, and not just because this country's position is the mirror image of Japan's: the world's largest debtor by most accounts. The Commerce Department stopped publishing the total figures this year, substituting explanations as to how the components of such totals are flawed. For example, America's mammoth foreign direct investment, which, even according to offical figures, is well over twice that of Japan's, is understated because it is valued at historical cost rather than current market value. (Commerce promises a new, improved data series next year.) However, several independent analysts have concluded that, while the size of America's debtor position is overstated, the decline in its position in recent years is approximately correct. If one disregards Commerce's objections and uses its data, the United States owed foreigners $663.7 billion more in 1989 than was owed to this country, up from $531.1 billion in 1988.

Japan's data reveals several interesting patterns. For example, private and government asset holders switched roles in 1989. Between 1987 and 1988 net official assets increased sharply, offsetting sluggish rates of growth in private overseas investment. But in 1989 overall net assets rose despite a sharp decline in official assets. The turnabout probably reflected a change in Bank of Japan intervention in foreign currency markets. In 1988, when the yen still was appreciating in value, the Bank of Japan substituted for private Japanese buyers of U.S. and other foreign government securities, adding to its foreign exchange reserves and thereby putting a prop under the dollar. Last year, however, the yen and the dollar reversed roles; it was the Japanese currency that needed help. As a result, BOJ reduced its foreign exchange reserves substantially, reflected in part in the decline in short-term government assets (see Table 2).

Table 2: Japan's External Assets and Liabilities, 1988 and 1989

(in millions of dollars)

	Assets		Liabilities	
	End of 1988	End of 1989	End of 1988	End of 1989
Long-Term	$832,669	$1,019,218	$311,625	$447,472
Private Sector	728,168	901,736	268,431	405,498
Direct Investments	110,780	154,367	10,416	9,160
Trade Credits	48,791	52,866	23	16
Loans	123,663	137,084	1,061	18,895
Securities	427,218	533,781	254,886	373,990
Others	17,716	23,638	2,045	3,437
Government Sector	104,501	117,482	43,194	41,974
Loans	55,570	60,471	26	7
Others	48,931	57,011	43,168	41,967
Short-Term	636,678	751,785	865,976	1,030,316
Private Sector	538,802	666,712	850,968	1,004,111
Monetary Movements	502,256	627,846	765,165	894,679
Others	36,546	38,866	85,803	109,432
Government Sector	97,876	85,073	15,008	26,205
Monetary Movements	97,869	85,072	5,144	16,957
Others	7	1	9,864	9,248
Total	1,469,347	1,771,003	1,177,601	1,477,788

Source: Bank of Japan, Balance of Payments Monthly, April 1990.

The composition of private assets also changed in 1989. The net position in securities actually declined, falling from $172.3 billion to $159.8 billion or 7.3 percent. However, direct investment abroad soared by nearly 40 percent over the 1988 level to $154.4 billion. This figure is understated to the extent that overseas investments financed abroad may not be reflected. In addition, Japan's 1989 balance of payments figures included an unusually large $22 billion errors and omissions entry that may represent, in part, unreported outbound capital flows that presumably are not reflected in the tables. (Errors and omissions came to $2.8 billion in 1988.) This large number could distort figures in the tables as well as the net change in Japan's asset position. Thus, most analysts use this set of Japanese statistics -- like their U.S. equivalent -- with considerable caution.

Douglas Ostrom

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REPORT

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JAPAN'S DEFENSE INDUSTRY

Summary

Japan's defense industry has been constrained over the years by a relatively limited defense budget and a ban on weapons exports. In the past these factors tended to make Japan's advanced armaments not only more expensive but inferior to their U.S.-made counterparts. The Japanese defense sector's growing success in applying leading-edge civilian technologies to military purposes, however, has helped change this situation, as has development of qualitatively improved systems. Recognizing these breakthroughs, the United States has tried to draw from Japan's well of high technology since concluding a 1983 agreement governing defense technology transfers.

Japan's emergence as the world's third-largest military spender behind the Soviet Union and the United States has raised questions in some U.S. quarters concerning the implications of this buildup for Japan's defense industry. Tokyo's proposed 1991-95 defense plan indicates that the Japan Defense Agency will continue to purchase some sophisticated systems from U.S. arms makers. But, due in part to the controversy over joint development of Japan's new fighter aircraft, FSX, Tokyo increasingly may favor the development of indigenous defense technology.

This likely shift will not be accompanied by an end to the ban on exports of military hardware. Japanese industry, however, can be expected to pose increasingly stiff competition in global markets for dual-use technologies. In terms of military hardware Japan's prime contractors may experience a flattening of growth due to anticipated smaller increases in defense spending and the attainment of some major equipment procurement goals. But

systems upgrades, involving electronic and other improvements, will be a boon to subcontractors.

Market Limitations

Japan's war-renouncing constitution and emphasis on maintaining strictly a self-defense capability have served to limit government spending on defense to around 1 percent of gross national product for most of the postwar period (see Table 1). Pacifist sentiments in Japan are still so strong that efforts to greatly exceed or even scrap the de facto ceiling -- established in 1976 by then Prime Minister Takeo Miki -- have provoked public outcry. Japan's commitment to permanent peace also is reflected in its 1967 policy banning weapons exports to communist countries, countries under United Nations sanctions and countries involved in or threatening to become involved in conflicts.

Table 1: Japan's Defense Budget, FY 1955-FY 1990

(in billions of yen)

Fiscal Year	Initial Budget	Percent Change	Ratio to GNP
1955	Y134.9	-3.3%	1.78
1965	301.4	9.6	1.07
1975	1,327.3	21.4	0.84
1980	2,230.2	6.5	0.90
1981	2,400.0	7.6	0.91
1982	2,586.1	7.8	0.93
1983	2,754.2	6.5	0.98
1984	2,934.7	6.6	0.99
1985	3,137.2	6.9	0.99
1986	3,343.6	6.6	0.99
1987	3,517.4	5.2	1.00
1988	3,700.3	5.2	1.013
1989	3,919.8	5.9	1.006
1990	4,159.0	6.1	0.99

Source: Japan Defense Agency

The country's generally strong economic growth in the past decade has enabled Tokyo to increase the defense budget by 5 to 8 percent annually without going much over the 1 percent GNP limit. As Table 2 indicates, weapons procurement has held a solid one-quarter-plus share of the budget, a distant second to personnel expenditures and just slightly ahead of the costs associated with maintaining both Japanese and American bases in Japan. Although the Y1.1 trillion ($7.3 billion at Y150=$1.00) earmarked for equipment purchases in the FY 1989 budget represented another in the continuing increases in weapons funding,

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Table 2: Allocation of Japan's Initial Defense Budget, FY 1985-FY 1989

Category	FY 1985	FY 1986	FY 1987	FY 1988	FY 1989
Personnel	45.1%	45.1%	43.9%	42.7%	41.2%
Supplies	54.9	54.9	65.1	57.3	58.8
Equipment Purchases	26.2	26.9	27.5	28.1	28.0
R&D	1.6	1.7	1.9	2.0	2.1
Facility Improvements	1.4	1.7	2.0	2.8	2.9
Maintenance	15.1	14.4	14.2	14.1	15.1
Base Countermeasures	9.5	9.0	9.4	9.2	9.5
Other	1.2	1.2	1.1	1.1	1.2

Source: Japan Defense Agency, Defense of Japan, 1989.

this level was still low compared to the whopping $79.7 billion the Pentagon spent in FY 1989 for hardware.

The effect of these budgetary and policy constraints has been to keep defense production as a share of Japan's total industrial output at a slim 0.6 percent (see Table 3). This low percentage suggests smaller production runs, which mean that Japan Defense Agency suppliers cannot realize economies of scale, a typical way of lowering costs in most sectors.

Table 3: Defense Production as Share of Industrial Production, FY 1979-FY 1987

Fiscal Year	Share
1979	0.39%
1980	0.36
1981	0.35
1982	0.46
1983	0.50
1984	0.48
1985	0.51
1986	0.55
1987	0.58

Source: Japan Defense Agency, Defense of Japan, 1989.

Not surprisingly, no major Japanese company is engaged solely in defense production. Unlike most Western countries, where arms manufacturers rely primarily on defense contracts to stay in business, Japan's defense industry is dominated by big, generally diversified companies that engage in weapons production on the side. The top five defense contractors (see Table 4) win an estimated 60 percent of the contracts awarded by JDA, but the military business generates a relatively small portion of their total revenues.

Table 4: Top 10 Japanese Defense Contractors, FY 1989

(in billions of yen*)

Ranking FY 1989	Ranking FY 1988	Company	Contract Awards	Change from FY 1988
1	1	Mitsubishi Heavy Industries, Ltd.	Y363.6	-0.2%
2	2	Kawasaki Heavy Industries, Ltd.	174.3	15.9
3	3	Mitsubishi Electric Corp.	111.7	10.8
4	6	NEC Corp.	71.0	-3.6
5	4	Toshiba Corp.	68.3	-18.0
6	5	Ishikawajima-Harima Heavy Industries Co., Ltd.	62.8	-18.9
7	7	Nippon Seiko K.K.	31.2	0.3
8	-	Hitachi, Ltd.	26.2	340.0
9	8	Komatsu Ltd.	23.6	0.0
10	9	Fuji Heavy Industries, Ltd.	21.6	-2.3

*The yen figures can be converted into dollars at FY 1989's average exchange rate of Y142.83.

Source: Japan Defense Agency

Keidanren (Japan Federation of Economic Organizations) recently gave several examples of the contrast between the dependence of Japanese and U.S. defense contractors on military spending. The Y83.1 billion ($647.8 million at FY 1988's average exchange rate of Y128.26=$1.00) worth of defense contracts won by the fourth-largest contractor in FY 1988, Toshiba Corp., for example, amounted to only 2.8 percent of the company's total revenues that year (see Table 5). Mitsubishi Heavy Industries, Ltd., Japan's top defense contractor, generated only 8 to 10 percent of its total revenues from defense work in the early 1980s, Keidanren estimated. While this figure had more than doubled by the end of the decade, MHI's dependence on defense contracts still was dwarfed by General Dynamics Corp.'s 68 percent, McDonnell Douglas Corp.'s 53 percent and Raytheon Co.'s 50 percent in 1989. Of Japan's top 20 arms manufacturers, only Japan Aircraft Manufacturing Co., Ltd., a parts supplier, is significantly dependent on defense contracts: military work accounted for 70 percent of the company's revenues in FY 1988 and more than 92 percent if military repair work is included.[1]

Defense Industry Players

Although a small group of firms dominates the industry -- with MHI far out front -- JDA typically will designate at least two manufacturers for most military hardware bids in an effort to foster competition.[2]

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[1] Tai Ming Cheung, "A Yen for Arms," Far Eastern Economic Review, February 22, 1990, p. 58.

[2] Bruce Roscoe, Defense Revisited (S. G. Warburg Securities, Japan, Inc.: July 1988), p. 42.

Table 5: Defense Contracts as Share of Revenues in 1988 Business Year*

(in millions of dollars**)

	Contract Awards	Share of Revenues
Japanese Contractors		
Mitsubishi Heavy Industries, Ltd.	$2,840	21.3%
Kawasaki Heavy Industries, Ltd.	1,172	19.6
Mitsubishi Electric Corp.	786	4.5
Toshiba Corp.	648	2.8
Ishikawajima-Harima Heavy Industries Co., Ltd.	603	12.6
American Contractors		
McDonnell Douglas Corp.	8,000	53.1
General Dynamics Corp.	6,500	68.3
General Electric Co.	5,700	11.5
Tenneco Inc.	5,000	38.2
Raytheon Co.	4,000	49.5

*For Japanese companies FY 1988 (April 1988-March 1989); for American companies calendar 1988.

**The yen figures were converted into dollars at FY 1988's average exchange rate of Y128.26=$1.00.

Source: Keidanren

Aircraft - MHI, Kawasaki Heavy Industries, Ltd. and Fuji Heavy Industries, Ltd. dominate the aircraft sector. As will be discussed below, MHI was chosen to codevelop with General Dynamics Japan's new fighter support aircraft, FSX, which will be modeled on the U.S. firm's F-16; KHI and FHI are the main Japanese subcontractors. MHI also has been the prime contractor for the F-15J and F-4EJ fighters, both licensed from McDonnell Douglas. KHI has the lead role in manufacturing the P-3C antisubmarine surveillance aircraft, licensed from Lockheed Corp. These three aircraft are mainstays of the Air Self-Defense Force.

Under license from Bell Helicopter Textron, Inc., FHI has been the prime contractor for the AH-1S antitank helicopter. It is now making the multipurpose HU1B/H helicopter and appears to have the inside track as prime contractor for a new antitank helicopter that JDA wants to procure in the 1990s. Shin Meiwa Industry Co., Ltd., one of the world's few manufacturers of "flying boats," makes the US-1, a search and rescue amphibious vehicle used by the Maritime Self-Defense Force.

Japan Aircraft Manufacturing makes part of the fuselage for the F-15J as well as pylons and missile launchers, engine nacelles for the P-3C and other parts for helicopters. Ishikawajima-Harima Heavy Industries Co., Ltd. is Japan's top manufacturer of engines for military aircraft. In FY 1989, for example, IHI had planned to produce 26 F100s for the F-15J under license from the

Pratt & Whitney division of United Technologies Corp.; 40 T56s for the P-3C under license from the Allison division of General Motors Corp.; and 40 of the domestically developed F3s for the T-4 trainer.

Ships - Five major shipbuilders supply the Maritime Self-Defense Force: MHI, IHI, Mitsui Engineering & Shipbuilding Co., Ltd., Hitachi Zosen Corp. and Sumitomo Heavy Industries, Ltd. Defense contracts have helped to keep builders afloat given the downturn in commercial orders over the past 10 years or so (see JEI Report No. 6B, February 9, 1990). JDA's plans to acquire four new destroyers equipped with the U.S.-supplied Aegis system, a sophisticated radar and weapons system, should be a boon to shipbuilders. MHI was tapped to install the system in the first warship, but IHI may win the second contract.[3]

Tanks and Artillery - Komatsu Ltd. and MHI are the leading suppliers of tanks. In a consortium with Hitachi, Ltd. they have developed the Type-90 model, which reputedly outperforms U.S. and West German tanks in its class. As will be discussed below, the Type-90 is considered one of the Japanese defense industry's success stories; features that set it apart from Western-developed models, such as its automatic firing and loading system and armor plating that can withstand direct hits, were developed domestically.

Komatsu, along with Howa Machinery, Ltd., Nittoku Metal Industry Co., Ltd. and Japan Steel Works, Ltd., also provide ammunition. Komatsu makes turret drives for armored cars under license from General Electric Co. as well as howitzers and artillery gun barrels. JSW focuses principally on artillery, although it does some assembly of tanks and other military vehicles for MHI. Howa is an important supplier of rifles, and NMI produces machine guns for JDA.

Missiles - MHI also excels in missile production, both those developed in-house and those licensed from U.S. producers. MHI is the lead company for licensed production of Raytheon's Patriot, a high-altitude surface-to-air missile; Mitsubishi Electric Corp., NEC Corp. and Toshiba are subcontractors. MELCO, however is the prime contractor for Raytheon's low-altitude surface-to-air HAWK missile and reportedly is working with Toshiba and MHI, in cooperation with JDA, on research for a HAWK replacement. MELCO also is involved in developing the phased-array radar system that will be used in the FSX.

In addition to producing the Patriot and the HAWK, defense companies are engaged in several missile projects that rely exclusively on indigenous technology. Toshiba is the prime contractor for Keiko, a shoulder-fired, surface-to-air missile that uses a charge-coupled device to home in on targets. MHI and MELCO are contractors for the XGCS bomb guidance unit, an add-on system that converts conventional bombs into guided missiles, such as the U.S.-made Paveway. However, the XGCS uses infrared homing rather than the laser guidance found in the Paveway. MHI also is involved in projects to supply JDA with air-to-air (XAAM-3), ship-to-ship (XSSM-1B) and air-to-ship (XAXM-1C) missiles as well as an antiship, antiradar missile, ARM.

Defense Self-Reliance

Given the relatively small size of Japan's defense industry, some American policymakers have argued that it makes little economic sense for Tokyo to

[3] Ibid., p. 43.

encourage the production of military equipment that can be produced more efficiently in this country and elsewhere. The Japanese government, however, actively promotes self-reliance in arms production. Tokyo has accepted the diseconomies inherent in military work in order to build a viable defense industrial base. While JDA continues to purchase off-the-shelf some sophisticated frontline equipment from the United States, for the most part the agency favors systems produced domestically, either under license or developed indigenously (see Table 6). About 99 percent of the MSDF's warships and more than 80 percent of the aircraft, ammunition and firearms procured by the Ground Self-Defense Force come from domestic companies.[4]

Table 6: Share of Domestic Purchases in Total Procurement, FY 1979-FY 1987

Fiscal Year	Share
1979	85.2%
1980	88.5
1981	80.5
1982	88.6
1983	90.3
1984	90.7
1985	90.9
1986	90.8
1987	91.0

Source: Japan Defense Agency, Defense of Japan, 1989.

There are political, strategic and economic reasons why JDA has pursued this more expensive and time-consuming approach to procurement. Like most industrial countries, Japan does not want the security risks that come with being overly dependent on foreign sources for military equipment. The 1985 Defense White Paper urged self-sufficiency in defense production for this reason, as does the defense production committee of Keidanren.

But JDA recognizes that in some sectors Japanese companies lag significantly behind their Western counterparts. In these cases the agency has opted for and will continue to choose licensed production so that an array of domestic manufacturers -- not just prime contractors -- can acquire technological expertise they lack. Table 7 gives an indication of how many companies benefited from JDA's decision in the late 1970s to produce McDonnell Douglas' F-15 fighter under license. Similarly, the Patriot missile project, for which MHI is the prime contractor, will keep busy a range of subcontractors: FHI is providing launching gear; MELCO is responsible for radar and guidance equipment; Hitachi is in charge of power supply and data link systems; and Asahi Chemical Industry Co., Ltd. is providing the rocket motor ignition system. The U.S. government has supported these coproduction arrangements as a means of both ensuring systems interoperability between American and Japanese forces and fostering close political relations.

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[4] Cheung, op. cit.

Table 7: F-15 Subsystems Contractors

Subsystem	Product	Company
Gun Mounts	AN/APG-63	Mitsubishi Heavy Industries, Ltd.
Radar Display	OD-60A	Tokyo Keiki Co., Ltd.
Data-Link Receivers	Japanese system	Hitachi, Ltd.
UHF Receivers	AN/ARC-164	Mitsubishi Electric Corp.
Instrument Displays	AN/AVQ-20	Shimadzu Corp.
Instrument Displays	Parts	NEC Corp.
Computing Gyro	CN-1377/AWG	Toshiba Corp.
Inertia Navigation	AN/ASN-109	Toshiba Corp.
Direction Finder	DA/8639/ARD	Mitsubishi Electric Corp.
IFF Device	RT-868A/APX-76	Toyo Communications Equipment Co., Ltd.
Attitude Indicator	AN/ASN-108	Tokyo Keiki Co., Ltd.
Pressure Reader	AN/ASK-6	Tokyo Keiki Co., Ltd.
Radar	Japanese system	Tokyo Keiki Co., Ltd.
20 mm Guns	M61A1	Sumitomo Heavy Industries, Ltd.

Note: Unless otherwise noted the technology for these subsystems belongs to the Department of Defense or individual American companies.

Source: Wing, July 26, 1978 as cited in "Nihon no Heiki Kojo," Satoshi Kamata, October 15, 1983.

Civilian/Military Linkage

In deciding on procurement Tokyo has emphasized licensed production of aircraft and missiles. This experience, in turn, has enabled Japanese industry to develop replacement systems using indigenous technology. For example, Toshiba's Keiko surface-to-air missile replaces the U.S.-made Stinger SAM; MHI's XAAM-3 air-to-air missile replaces another American system, the AIM-9L Sidewinder. MHI, MELCO and Toshiba are sufficiently confident with the knowledge gained through production of the HAWK that they want to develop a follow-on system for deployment in the late 1990s. Likewise, the Japanese manufacturers involved in the Patriot project anticipate considerable technological spin-offs that they expect to apply to future-generation systems.

Industry analysts maintain that the success of Japanese companies in missile development also is a testament to arms makers' skill in applying sophisticated electronics technology originally developed for commercial use to some of their defense systems. This transfer probably arose out of necessity. Government funding for defense R&D has drawn only about 2 percent of the defense budget in recent years. In FY 1988 this amounted to Y73.3 billion ($488.7 million) as compared to the $36.8 billion earmarked for R&D by the Department of Defense.

JDA's Technical Research and Development Institute, which is primarily responsible for defense research, has backed some not insignificant domestic projects, such as the portable Tan SAM (which uses both light image and infrared homing), the T-2 trainer (the first domestically developed supersonic jet for advanced pilot training) and its T-4 successor, and the F-1 fighter support aircraft. However, industry representatives assert that, if the defense sector is to achieve self-reliance, increased government funding for research and development is imperative.

Keidanren's defense production committee has insisted that R&D spending should be increased to at least 5 percent of the defense budget; that would bring it in line with the amounts appropriated by Western industrial countries. While TRDI's budget has expanded in recent years, the current mood of fiscal restraint as well as a variety of domestic and international political factors make sizable increases unlikely in the foreseeable future.

What has facilitated the defense industry's borrowing of commercial technology is the almost complete integration of military and civilian work in most of the companies that do work for JDA. This is not the case in the United States, where tough procurement regulations often mean that American companies with both defense and civilian contracts maintain completely separate production lines, engineering teams, and bookkeeping and accounting systems. Some analysts, in fact, have pegged this lack of integration as a main cause of the problems U.S. industry is having in adapting to cutbacks in defense spending and changing market conditions (see JEI Report No. 24A, June 22, 1990).

Perhaps one result of this separation has been the increasing reliance of U.S. arms makers on Japanese commercial technologies with military applications or dual-use technologies. Some examples are Toshiba, the largest supplier of semiconductors to U.S. defense contractors, and Sumitomo Electric Industries, Ltd., which produces optical fibers that reportedly are being considered for use in a next-generation antitank missile being tested by the Army.[5] American policymakers have grown more and more concerned about this dependence, which they fear will discourage domestic manufacturers from risking investment capital. The result, they worry, could be a fizzling of U.S. competitiveness (see JEI Report No. 24A, June 24, 1988).

Conversely, the Pentagon is keenly interested in Japanese industry's ability to develop new military technologies using commercial technological advances as a springboard. At Washington's urging the two countries in 1983 exchanged diplomatic notes that, in effect, give the United States access to Japanese defense technology. After seven years the agreement has resulted in just two exchanges of Japanese-developed technology -- one to clean ship hulls and the other for drydock upkeep; naturally, the Pentagon is disappointed.

American defense planners, in pushing for joint development and production of the FSX, had hoped that this project would allow U.S. industry greater access to Japanese military technology. The November 1988 memorandum of understanding and April 1989 side letters governing the accord stipulate that any Japanese improvements to F-16 technology must flow back to the United States (such as co-cured composite wing technology), while technologies developed independently by Japanese companies would be available to American contractors for a fee. Washington specifically indicated that it wanted access to such technological advances as active phased-array radar, the inertial navigational system, electronic countermeasures and the mission (weapons control) computer hardware system (see JEI Report No. 18B, May 5, 1989).

[5] "Weapons Wizards," Business Tokyo, June 1990, p. 24.

When Defense Secretary Richard Cheney visited Japan in February 1990 to discuss Washington's plans to restructure American forces in Asia, he presented a list of military technologies that DOD wants Japan to transfer to the United States. These technologies, which have been under discussion for at least the past two years, include improved missile homing devices, next-generation tank armor and submarine warfare technologies (see JEI Report No. 33B, August 26, 1988). A formal agreement pledging Japan's cooperation reportedly may be signed in the near future.[6]

Aerospace Technology Grab?

The Japanese defense industry's experience in missile and tank development demonstrates its innovative capacity, particularly in the adaptation of civilian technologies. Japan's approach to aircraft development, however, has engendered concerns in some American quarters that progress in this area ultimately may hurt U.S. defense contractors as well as commercial aerospace manufacturers.

Citing the Ministry of International Trade and Industry's 1980 industry "vision," which emphasized development of Japan's commercial aircraft sector, a 1982 study by the General Accounting Office concluded that technology transfers from coproduction programs, such as those for the F-15, significantly enhanced private-sector airframe and engine production capabilities. A 1984 Defense Science Board report also underscored the Japanese government's role in supporting the development of high-technology industries, its drive to develop self-sufficiency in production of military hardware and the perceived link between commercial and defense projects. American journalists who observed MHI's MU-300 Diamond business jet being assembled next to the F-15J production line concluded -- without much technical evidence -- that the fighter aircraft's technology was making its way into a civilian plane; this, too, appeared to lend further credence to reports of commercial technology grabs.

Some analysts rebut that Japanese commercial aircraft producers never have banked on military technology transfers to improve their capabilities in the civilian area but instead have relied on partnerships with foreign manufacturers for up-to-date commercial airframe and engine technologies (see JEI Report No. 34A, September 1, 1989). However, the ups and downs of this strategy in the airframe field -- notably, Boeing Co.'s December 1987 shelving of a plan to develop an advanced-technology 150-seat plane with MHI, KHI and FHI as equity partners and the trio's decision to play a subcontractor-plus role in Boeing's 767-X project (see JEI Report No. 17B, April 27, 1990) -- apparently have increased the importance of any commercial spin-offs Japan can obtain from defense joint ventures like the FSX.

That was precisely the issue U.S. legislators seized during the spring of 1989 when, using their authority to review export license applications (for the transfer of General Dynamics' F-16 technology), they nearly killed the FSX deal (see JEI Report No. 21A, May 26, 1989). Pentagon proponents of the FSX project insisted that fighter airframe technology cannot be applied readily to the production of commercial transports. Moreover, the key flight control technology, which indeed would have commercial applicability, would not be transferred to prime contractor MHI, they pointed out.

[6] _Ibid._, p. 25.

The extent to which General Dynamics' technology makes its way into Japanese commercial aircraft will be seen in time. Judging by the intercompany wrangling that further delayed the start of the project until this spring, this could come much later rather than sooner. The development phase of the project was held up by the inability of MHI and General Dynamics to agree on implementation arrangements. After nearly 10 months of negotiations the two industry giants concluded a contract in late February 1990 governing joint development and production of the new fighter (see JEI Report No. 9B, March 2, 1990).

Representatives from MHI and General Dynamics now are grappling with design questions at MHI's Nagoya Aircraft Works. DOD's official word is that the FSX is on track. Industry sources maintain, however, that the dimensions of the project have been grossly underestimated. Reams and reams of data must be analyzed to determine whether the FSX design is operationally sound, a somewhat daunting task. Concerns also have been voiced that questions about the flowback of Japanese technology again will rear up as work on the prototype begins. In addition, MHI's choice of an engine for the aircraft can be expected to reactivate debate in Congress and in certain executive branch agencies concerning technology transfer safeguards.

Delays and unanticipated costs recently prompted MHI to ask JDA to budget an additional Y500 million ($3.3 million) on top of the original Y165 billion ($1.1 billion) allocated for FSX design and development. The request stems from inaccurate airframe design and development cost projections as well as MHI's decision to develop independently the source codes for the mission control computer. The latter decision alone drives expenses up Y100 million ($667,000).

MHI also has asked JDA to extend the deadline for the start of FSX production one more year. Assembly of the first prototype was to begin in 1991, and its demonstration flight was set for 1993. The flight test program was supposed to be finished by 1996, with the first aircraft coming off the assembly line in the fall of 1997. Now, however, delays may prevent the Air Self-Defense Force from receiving its first FSX until 1998.

Some Japanese defense analysts are concerned that the new fighter aircraft may fall victim to the budget ax if Tokyo decides that its 1991-95 defense plan should be scaled back to reflect changes in the international order. While spending cuts are possible, at this stage funding for FSX design and development work is expected to continue at least through March 1992.

Planning for the New World Order

The attention of Japan's defense industry is riveted to negotiations for the next five-year defense plan. The extent of the industry's growth and greater self-reliance will be determined in part by these talks. The government's National Security Council, which met in mid-June and again in early July to discuss the 1991-95 plan, has urged Tokyo to continue modernizing its armed forces despite political, economic and security changes in the Eastern bloc and improvements in U.S.-Soviet relations. "It is necessary to see through the consequence of the current historical changing of world situations," the NSC report stated. Arms control is not yet progressing similarly in the Asian region, and regional instability is possible, defense officials add.

JDA wants the new medium-term plan to include funds for several advanced systems in addition to the FSX. For the most part these would be purchased off-the-shelf from the United States. They include: AWACS (airborne warning and control system) aircraft, the multiple-launch rocket system, tanker refueling aircraft and Aegis systems. JDA also is lobbying for money to establish a headquarters for intelligence gathering and analysis with a staff of 2,000. General improvements in living and working conditions for SDF members would bring the total requested for the next five-year plan to Y2.3 trillion ($15.3 billion) as compared to the Y1.8 trillion-plus ($12.3 billion) budgeted for the 1986-90 plan. (Not anticipated are boosts in funding for studies related to the Strategic Defense Initiative, which also is being challenged in Congress in light of changing security needs and U.S. fiscal problems.)

Pentagon sources maintain that Washington generally is satisfied that the 1991-95 plan as now envisioned will assure continued improvements in Japan's self-defense capabilities. However, domestic critics are severe. The opposition parties have argued that the plan should be reevaluated with an eye toward reducing Japan's military power in accordance with the easing of world tensions. They, along with certain members of the ruling Liberal Democratic Party, have suggested that the program encompass only three years to allow the government greater flexibility in adapting Japan's defense effort to improvements in East-West relations.

Industry observers will not be held in suspense much longer. JDA must submit its budget proposal for FY 1991, the first year of the plan, to the Ministry of Finance by the end of August, at which time the elements of the five-year plan no doubt also will be made known. Judging by a late July meeting between Finance Minister Ryutaro Hashimoto and JDA director general Yozo Ishikawa, however, the outlook for beefed-up expenditures is not too promising. The two officials agreed that the growth in the defense budget for the April 1991-March 1992 period should be held at 5.8 percent; JDA had been pushing for a 6.3 percent increase, citing the yen's weakening against the dollar, which has pushed up the purchase price of American-made equipment (see JEI Report No. 30B, August 3, 1990).

This limitation probably will cause delays in FY 1991 procurement of big-ticket U.S. systems, such as the MLRS and AWACS, although Tokyo might support allocation of monies for this hardware during the FY 1992 or FY 1993 periods.[7] Suffice it to say, industry observers anticipate intense interministerial bargaining and pressure from Japanese defense contractors; that may change policymakers' sentiments before they formally submit the plan later this month. (Note: A forthcoming JEI Report will present a more comprehensive treatment of the 1991-95 plan and the international and domestic factors that influenced its development.)

Industry Outlook: Arms Merchant?

With Tokyo's defense budget now ranked third behind the two superpowers, some Western commentators speculate that in the not-too-distant future Japan will achieve defense self-reliance and may even become a global arms merchant. This is an unlikely scenario for several reasons. To say Japan is the third-largest military spender -- in dollar terms -- presents a misleading picture because of the steep appreciation of the yen in the 1985-88 period. More important, Tokyo's defense spending will continue to be hamstrung by general budgeting problems as well as domestic and international sensitivities to fears of a revival of Japanese militarism. These constraints will limit the size of Japan's defense market for the foreseeable future.

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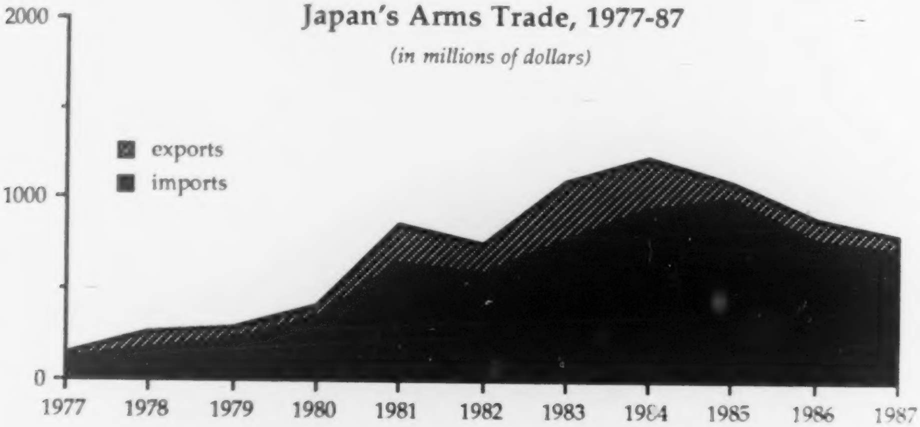
[7] Aerospace Japan Weekly, July 9, 1990, p. 2.

Equally important, before Japan could enter the global arms market it would have to lift its ban on the export of military hardware. Some analysts maintain that Japanese industry already has found ways to get around the export ban. Figures compiled by the U.S. Arms Control and Disarmament Agency would appear to substantiate these claims (see Figure). Certainly the proliferation of dual-use technologies and the blurred lines between military and nonmilitary equipment applications have complicated MITI's efforts to regulate the arms trade (see JEI Report No. 7A, February 20, 1987).



Source: U.S. Arms Control and Disarmament Agency, *World Military Expenditures and Arms Transfers, 1988*

Most industry experts concur that in the foreseeable future Tokyo will not lift the export ban on military hardware. To do so would create more problems than opportunities. The global defense market already suffers from overcapacity. Japanese industry's entrance into this market during a time of defense spending cuts in the United States and in many European countries would precipitate ferocious competition for third-country sales. This, in turn, would exacerbate already tense economic relations between Japan and its Western allies. In fact, there is a view that Tokyo would lift the export ban only under a radical change in its approach to foreign relations in general and U.S.-Japan relations in particular.

Experts agree, however, that while the defense business of MHI, KHI and their brethren probably never will approximate that of General Dynamics, Japanese producers of a variety of dual-use products could give their American competitors a run for their money during the coming decade. Japanese manufacturers of fiber optics, avionics systems and other leading-edge technologies could build up substantial defense-related businesses without violating the weapons export embargo.

A third important point concerning Japanese industry's potential for self-reliance deals with technological gaps and product quality. Although Japan's defense contractors in the past decade have made important strides in developing indigenous technology -- as demonstrated by their missile and tank programs -- the industry still is far from producing frontline systems that can match those of the United States or the Soviet Union. In radar technology, for example, it has been estimated that leading Japanese companies, such as MELCO, still lag 10 to 15 years behind the United States. Similarly, Japanese arms makers have nowhere near the technology and applications knowledge necessary to replicate an AWAC system.

There also have been instances where indigenous weapons systems have failed to meet JDA specifications. Orders for MELCO's AEWX antiaircraft propelled vehicle reportedly were cut from 130 to 30 when it was found that the system was too slow in engaging targets. The forerunner of Toshiba's Keiko surface-to-air missile also was plagued with operational difficulties; since the CCD depends on light to stalk enemy aircraft it could not be used at night or in inclement weather unless mounted on a Stinger-style infrared guidance system. Analysts blame these shortcomings on lack of competitiveness within the industry.

By the same token the tremendous strides that Japanese defense makers have made in developing military technologies cannot and should not be dismissed. This no doubt motivated the Pentagon to approach Tokyo concerning joint research and transfers of military technologies. Qualitative improvements to both locally designed and licensed systems will continue.

Rather than an export drive in the making, industry analysts foresee a flattening of growth in the defense sector. Budgetary constraints are one reason. Although military spending is difficult to project at this stage, the pending five-year defense plan may call for spending increases in the 4 to 5 percent range compared to the nearly 6 percent growth rate enjoyed during most of the 1986-90 program.

In addition, most of JDA's goals for hardware procurement either have been met or are in the process of being met. Future needs will be satisfied through improving existing systems. Upgrades of the F-15J, for example, will involve incorporation of Japanese-made electronic and other components. This will be a boon to smaller subcontractors, while the primes may have little more to do than "plug in the parts." Thus, not only will industry growth slacken but there could be some reshuffling of the players.

For further information, contact Barbara Wanner.

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The views expressed in this report are those of the author and do not necessarily represent those of the Japan Economic Institute.

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FORMER JAPANESE PUBLIC CORPORATIONS: POST-PRIVATIZATION UPDATE

Summary

Although they have been "privatized" for several years, the best known Japanese public service corporations -- Nippon Telegraph and Telephone Corp., Japan Railways Group, Japan Airlines Co., Ltd. and Japan Tobacco Inc. -- are not free of government control. At the same time Tokyo has deregulated to varying degrees the markets that these ex-public corporations once considered their fiefdoms. Facing a newly competitive environment, these companies have responded with new services and diversification. Since privatization began in 1985 (see JEI Report No. 26A, July 12, 1985), the former monopolies have taken varied paths. Whether they have helped create a foundation for a strong future and for the ongoing development of Tokyo's privatization program remains to be seen.

Background

Japan has a tradition of state-owned and -managed service corporations, in contrast to the United States, where the government has limited its role in providing certain types of public services to granting monopolies or exclusive geographic areas of operation to the private sector (electric utilities, for example). Catching up with the West economically, technologically and, sometimes, militarily has occupied Japan since the late 19th century. One of the government's first modernization experiments, establishing the Japanese National Railways in 1872, succeeded in building not only a rail system but a private railroad industry as well.

The daunting task of rebuilding the economy's infrastructure after World War II, combined with the guiding influence of the American occupation advisers, led Tokyo again to resume its prewar direct hand in providing critical public services. A branch of the Ministry of Transportation was reorganized into JNR in 1949. Japan Tobacco and Salt Public Corp. was founded the same year by merging two government monopolies. Organized in 1951 as a special private corporation was Japan Air Lines Co., Ltd., with the Minister of Transportation's status as largest stockholder guaranteed by law. Two years later Kokusai Denshin Denwa Co., Ltd. was formed under the guardianship of the Ministry of Posts and Telecommunications. Nippon Telegraph and Telephone Public Corp. was founded in 1952 as a wholly owned government company; while modeled after American Telephone & Telegraph Co., including a research laboratory arm, it was barred from manufacturing telecommunications equipment. Although these five are the biggest and best known public corporations, Tokyo spawned more than a dozen other specialized firms to assist the postwar reconstruction effort, including Housing Loan Corp., Japan Development Bank, Export-Import Bank of Japan, Medical Loan Corp. and Environmental Sanitation Corp.

In the immediate postwar period Japan's system of public service corporations on the surface was similar to the mix of government-sanctioned monopolies and government-owned and -operated companies present in the United States. There were important differences, however. AT&T always has been a private company forced to meet shareholder expectations, while NTT was a government corporation beholden only to bureaucrats. JAL enjoyed greater privileges and support from Tokyo than Pan American World Airways or Trans World Airlines ever got from Washington in the early days of international aviation. JNR had no American equivalent until the 1970s when AMTRAK was formed and, even then, the comparison is a poor one. The American cigarette market is populated entirely by private firms unlike Japan's government monopoly on production.

While the Japanese economy was rebuilding and growing rapidly, these characteristics of Japanese public service corporations were not issues at home or abroad. The twin oil shocks of the 1970s, however, generated direct and indirect forces that would put these companies in the spotlight. As the economy slowed under the impact of oil price hikes, many public corporations revealed a lack of flexibility in either dealing with labor unions, setting new prices or altering services. NTT, JAL, JNR and JTS experienced deteriorating bottom lines, and alarms sounded within the government. Some observers blamed government control for stifling the firms' ability to take swift, corrective action. Others extended the government linkage further, saying that a monopoly backed by the deep-pocketed government has no incentive to cut costs and/or improve performance. In any case the performance of many public corporations, and the largest ones in particular, fell behind the private sector in the 1970s. JNR, in particular, began running up huge debts as management maintained unprofitable services, expanded high-speed rail lines into sparsely populated areas and failed to cut costs.

The indirect impact of the economic dislocations of the 1970s were not evident until the following decade. Tokyo had responded to the economic slowdown in textbook fashion by raising government spending. The huge amounts of

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debt issued to finance this spending binge drastically increased the central government's interest payments. As a new decade dawned, the debt-service costs, combined with concerns about inflation and future fiscal soundness, forced reassessments of both fiscal policy and the structure of government. Studies by several ad hoc committees on administrative reform culminated in a 1983 report that recommended reorganizing JNR, NTT and JTS into special firms with private management but stock held by the government and/or restricted to Japanese citizens. The prospect of privatizing the gargantuan JNR and NTT boggled the minds of many Japanese, but then Prime Minister Yasuhiro Nakasone was determined to shrink the size of government. He targeted April 1, 1985 as the privatization date for NTT and JTS, with JNR to follow two years later.

Mr. Nakasone's proposal set off a raging debate in and outside of Japan involving parochial interests as well as principles. While intrigued by the explosion of competition and innovation set off by Washington's deregulation of the airline, petroleum, financial services and telecommunications industries in the early 1980s, many Japanese were unimpressed with the chaos of bankruptcies and takeovers that went hand in hand with deregulation American-style. The breakup of AT&T was particularly messy from a Japanese perspective and served as a model of what not to do in the debate over NTT's future. Yet a consensus began to grow that the hand of government had become unnecessary and even counterproductive to the efficient provision of some public services. For the Japanese, who have traditions of deference to authority and of paternalistic government, this was something of a revolution in attitude.

As bureaucrats planned the transition from public monopoly to private competitor parochial interests began stirring. The affected ministries were aiming for as smooth a transition as possible. NTT and JTS, for example, were allowed to retain the majority of their assets, guaranteeing them a strong competitive position and preventing disruptions in service. In exchange, they were forced to maintain some unprofitable services or operations. Labor unions and opposition parties focused on job security and workers' rights in the new private firms, tying up passage of enabling legislation until their concerns were met. As a result, the newly private firms found their options tightly restricted from the start with regard to strike provisions, hiring and firing procedures and pension plans.

Foreigners saw quickly that privatization of NTT and JTS and deregulation of their lucrative markets represented a golden opportunity. Under intense pressure from Washington and European capitals Tokyo generally guaranteed foreign firms equal access to the newly deregulated telecommunications equipment and services and cigarette markets. American and European companies joined domestic competitors of NTT, while foreigners provide the only competition in the sale of cigarettes.

By accommodating both domestic opposition and foreign demands, Mr. Nakasone won Diet approval in 1984 of the privatization plans for NTT and JTS, effective the following April. Although not directly named in the legislation deregulating the domestic telecommunications equipment and services market, KDD lost its monopoly in the international telecommunications services area. (It remains a special private corporation, however, with the Japanese government as the largest shareholder.) Mr. Nakasone overcame strong labor union opposition to reorganizing JNR in 1987 by holding out privatization as the sole salvation for the debt-ridden railroad. JAL was freed from Tokyo's control (on paper at least) in November 1987 when, following Diet repeal of the Japan Air Lines Co., Ltd. Law, the government sold its then 34.5 percent stake.

Tokyo's administrative reform program can claim, therefore, to have achieved the goal of reducing the government's size and its role in specific markets. Whether the program can be considered a success, however, is debatable. Several years of private management have had an obvious impact on these former public monopolies, but their results vary.

NTT: Avoiding a Breakup

When it was clear that Japan's domestic telecommunications market would be opened to competition, Japanese and foreign analysts predicted a boom in the offing. For a change, the prognosticators proved correct. Not only has the entry of new common carriers boosted inter- and intra-city telephone use, but a wide range of secondary service markets has sprouted. (For a review of Japan's telecommunications market, see JEI Report No. 46A, December 8, 1989.) Although NTT has used its new freedom to respond aggressively to new challenges, the results have been unsatisfactory to some. This dissatisfaction has generated calls for an AT&T-style breakup of NTT (see JEI Report No. 15B, April 13, 1990). After rallying its allies and some intense behind-the-scenes talks, a decision on a breakup was postponed earlier this year until at least 1995. NTT management realizes that the giant firm must fulfill bureaucratic and popular expectations if the threat of a breakup is to be permanently averted.

Competitive environment - Although the market was thrown open April 1, 1985, competitors in NTT's bread-and-butter markets did not appear until late 1986 (for leased circuits) and late 1987 (for telephone service). Since then more than a dozen firms have challenged NTT in every market segment, ranging from radio pagers to mobile telephones. Nevertheless, NTT continues to dominate every market in which it is active. While all three competing private common carriers managed for the first time to post net profits in the year ending March 31, 1990, NTT still recorded sales nearly 60 times greater than the largest of them. Even in the market for pocket-paging services, which is structured as a duopoly that pits NTT against one newcomer in each of two distinct geographic zones, NTT commands about a 75 percent market share nearly two years after the first of its competitors began offering services.

In secondary service markets competitors never allowed NTT's grip to become a stranglehold. Financially and technologically strong competitors, such as the Japanese subsidiary of International Business Machines Corp. and Japanese electronics makers, have built solid positions in the value-added network market. Although criticized for blocking technological innovation, the Ministry of Posts and Telecommunications has helped competitors overcome NTT's inherent advantages through its open-information policy for format and interface standards.

Financial Results - Reorganization may have slowed the growth of NTT's operating revenues since FY 1985 (see Table 1). The giant posted a 5 percent-plus gain in operating revenues in FY 1986 and FY 1987 but saw this increase dwindle to just over 3 percent the following two years. The rise in operating expenses, in contrast, has accelerated. As a result, the figures for operating income have been disappointing, hitting a peak in FY 1987 and then falling below the FY 1985 level in the business year ending March 31, 1990.

Table 1: Consolidated Financial Summary for Nippon Telegraph and Telephone Corp., FY 1985-FY 1989

(in millions of yen for the years beginning April 1)

	FY 1985	FY 1986	FY 1987	FY 1988	FY 1989
Operating Revenues	Y5,091,409	Y5,353,582	Y5,662,001	Y5,841,897	Y6,022,359
Telephone	4,233,722	4,368,895	4,553,766	4,622,668	--
Telegraph	52,547	49,141	49,844	53,393	--
Leased Circuits	251,408	275,168	295,405	334,347	--
Data Communications	153,282	162,388	176,109	186,045	--
Terminal Equipment Sales	142,423	222,701	248,846	258,957	--
Miscellaneous	258,027	275,289	338,031	386,487	--
Operating Expenses	4,333,662	4,549,093	4,747,495	5,026,490	5,316,646
Personnel	1,748,804	1,837,353	1,877,527	2,030,231	--
Depreciation	1,469,094	1,419,619	1,390,886	1,458,736	--
Other	1,115,764	1,292,121	1,479,082	1,537,523	--
Note: Research and Development	136,209	149,255	181,718	221,692	--
Operating Income	757,747	804,489	914,506	815,407	705,713
Nonoperating Revenues	12,115	14,129	16,359	12,371	76,784
Nonoperating Expenses	396,441	407,707	354,408	307,891	271,950
Nonoperating Income	-384,326	-393,578	-338,049	-295,520	-195,166
Income Before Taxes	373,421	410,911	576,457	519,887	510,547
Income Taxes	187,733	218,248	309,270	256,275	236,800
Net Income	185,688	192,663	267,187	263,612	273,747
Total Assets	11,368,637	11,377,534	11,455,925	11,559,657	11,421,443
Current Assets	889,249	997,796	1,080,466	1,244,968	1,542,217
Fixed Assets	10,156,968	9,961,092	9,940,441	9,775,823	9,858,189
Other	322,420	418,646	435,018	538,866	21,037
Liabilities and Shareholders' Equity	11,368,637	11,377,534	11,455,925	11,559,657	11,421,443
Current Liabilities	1,555,078	1,575,512	1,651,159	1,650,816	2,021,051
Long-Term Liabilities	6,301,795	6,214,595	6,028,152	5,946,615	5,397,482
Shareholders' Equity	3,511,764	3,587,427	3,776,614	3,962,226	4,002,909

Source: Nippon Telegraph and Telephone Corp., Annual Report, 1987, 1989, 1990.

On the bright side, a tremendous jump in income from nonoperating sources in FY 1989 combined with a steady drop in nonoperating costs to pare the red ink for that year to almost half of the loss recorded five years earlier. Thanks to the abolition of special NTT tax levies and the freedom to plan for tax liabilities as if it were a private corporation, NTT has managed to hold down its tax bill. As a result, net profits have performed better than net operating income, showing growth over the past five years except in FY 1988.

As for its balance sheet, NTT's assets have not suffered from deregulation but neither have they benefited. The growth of total assets, which was just 1.7 percent between FY 1985 and FY 1988, actually turned negative in FY 1989 (down 1.2 percent). Management has been able, however, to pare NTT's long-term debt and boost shareholders' equity. The quality if not the quantity of NTT's assets, therefore, shows considerable improvement since reorganization.

Current Challenges - Despite its positive financial performance, NTT remains under fire from bureaucrats and the public alike. The Ministry of Posts and Telecommunications remains unhappy with management's approaches for cutting costs (particularly employment) and improving services. The ministry also is disappointed that NTT's domination of key markets so far has proved to be impervious to competition. Given that MPT continues to have a say in key areas (such as setting service rates) and that NTT's labor unions are backed by a much strengthened Japan Socialist Party, management may feel its hands are tied or at least sufficiently constrained to rule out bold moves. The world's largest private corporation finds itself in a paradoxical position: criticized by those who have some say in decisions for being too successful in some ways but not tough enough in others.

The public's unhappiness with the "new" NTT stems not from the quality of its service but from the plunging value of its shares. Tokyo hoped to auction off over several years at least one-half and as much as two-thirds of the 15.6 million shares issued when NTT went private. The first auction, held October 1986, was well-received; the price rose sharply from an initial Y1.2 million ($8,000 at Y150=$1.00) a share to a high of just over Y3.1 million ($20,667) in less than nine months. Since then, however, the price has drifted down, hitting Y2.6 million ($17,333) when the second batch of NTT stock went on the auction block in November 1987 and just Y1.9 million ($12,667) when Tokyo released a third tranche in October 1988. NTT stockholders did not escape the general pullback in the Tokyo Stock Exchange during the first quarter of this year, but their shares since have failed to ride the market's recovery. The per-share price closed at less than its debut level in mid-March (Y1.18 million or $7,867) and at precisely Y1 million ($6,667) in late July; since then it has sunk under this mark.

The declining price of NTT stock cannot be attributed to poor business results. Instead, the Recruit Cosmos Co., Ltd. influence-buying scandal and the resulting loss of public confidence in the government have stained the corporate giant. Former NTT president Hisashi Shinto allegedly tried to curry favor with then Prime Minister Nakasone by buying American supercomputers to help cool bilateral trade tensions. NTT reportedly turned around immediately and sold the machines (at a reduced price) to Recruit Co., Ltd., the parent company of Recruit Cosmos. When reports surfaced that key political figures and businessmen had profited from insider trading of Recruit Cosmos stock, NTT's dealings came to light and the respected former NTT head was put on trial for bribery.

On top of this setback came a crisis of confidence as the once highly touted shares lost their promise of being a safe investment for individuals. Ninety-eight percent of all NTT shareholders are individuals, although they hold only 17.5 percent of all shares. While institutional investors may be capable of absorbing the paper loss of having invested in NTT shares, many individuals could afford only one share; they have had to watch helplessly as NTT's stock value has fallen.

Not surprisingly, there is a sense of outrage among individual NTT stockholders that the company and the government have failed to keep some unspoken pledge to support the price of NTT shares. Although the Ministry of Finance tacitly encouraged stockbrokers to support the shares immediately before the second and the third auctions, the inability of either the government or the securities industry to prevent the price slide has soured investors' attitudes toward the stock. MOF actually reduced the number of shares offered in the third sale to prevent weak demand from depressing the price even more, and in 1989 it scrapped the scheduled sale of government-owned shares because of the bear market. Plans for a stock auction this year -- when the last government-held shares to be offered to the public originally were expected to be sold -- are on hold as NTT and MOF search for an effective response to the erosion of public confidence.

Future Plans - Failure to respond adequately to the many challenges confronting NTT could tilt the scales in the debate over the organization's structure. Given five years by the government to answer critics and restore the public's and Tokyo's confidence in it, the giant corporation will be working hard to duplicate the results AT&T has achieved in recent years. The management of NTT feels that the best response is to redouble the company's efforts to provide top-quality services while continuing to produce good financial results. To achieve this goal NTT plans to improve its core local and long-distance telephone businesses but is not ignoring other opportunities.

- Visual, intelligent and personal communications - Integrating voice, visual and text transmission services is NTT's goal into the next century. Based on an integrated services digital network (ISDN), NTT's first step toward giving users "a flexible choice of a wider range of services" is expected to take advantage of a quadrupling in size of the information industry between 1986 and 2005, which is projected to increase from Y12.8 trillion ($85.3 billion) to Y50 trillion ($333.3 billion). Digital electronic media also are predicted to expand their share of the market. Telecommunications and data processing will account for 70 percent of the industry's income, up from the current 50 percent, the telecommunications segment alone will jump from Y5.7 trillion ($38 billion) to Y23 trillion ($153.3 billion).

NTT's communications network of the future will use sophisticated image-processing services to convey high-definition images, high-resolution text and graphics and eventually three-dimensional images to individual users. The network also will provide "intelligence" in the form of automatic translation, security, data and secretarial services. Finally, users will be free to personalize their communications services, picking from a wide range of options and then tailoring them to meet individual preferences.

- Research and development - To implement its VI&P communications concept, rapid development and introduction of new technologies are critical. NTT's strong commitment to R&D spending is one obvious signal of the high priority assigned to this area. Outlays jumped 22 percent in FY 1988, reaching Y221.7 billion ($1.5 billion). FY 1990 projections top Y240 billion ($1.6 billion). While continuing its strong tradition of applied research, NTT also is devoting greater attention to basic research, not only because Tokyo is promoting basic R&D but because it could give NTT entree to nontelecommunications fields, such as computer software and medical/diagnostic equipment.

- Noncore businesses - Like other large Japanese corporations, NTT is trying to bolster its bottom line by creating specialized subsidiaries. While NTT's affiliated firms mostly are related to its core businesses -- telecommunications consulting, terminal equipment sales and information services -- some are not. Advanced Energy Technologies Inc., for example, is a joint venture with a Canadian firm to develop rechargeable lithium batteries. Although NTT's noncore strategy will continue to emphasize areas that support its core businesses, it cannot afford to ignore promising opportunities.

KDD: No Longer A Backwater

Unlike NTT, Kokusai Denshin Denwa was not restructured in 1985 since private investors have held a majority stake from its founding in 1953. The law governing it was amended, however. Nevertheless, when the Japanese telecommunications market was deregulated, KDD faced a wrenching experience similar to NTT's. Alone among the major public service corporations, KDD remains a special private corporation and continues to serve as Japan's "official" international common carrier. The Ministry of Posts and Telecommunications retains a large say in KDD affairs by virtue of its status as the largest shareholder (10.9 percent) and because it holds the authorization necessary for KDD's operating plans. In response to the changing telecommunications market, however, KDD is showing signs of greater independence.

Competitive Environment - Because the December 1984 Telecommunications Business Law does not specifically bar competition, two companies are challenging KDD in the international telecommunications market. International Telecom Japan Inc. and International Digital Communications Inc. have provided leased circuit services to neighboring Asian countries and other areas since the spring of 1989 and telephone service since October 1989. While they lease circuits and ground facilities from KDD for much of their operations, the two companies are trying to build independent networks. No foreign-owned competitors are in this field. Moreover, the outlook is slim for any additional entrants (domestic or foreign) as MPT feels the market already is overcrowded. Foreign firms are represented, however, through IDC, which is backed by Britain's Cable & Wireless Plc and America's Pacific Telesis International Inc. as well as Toyota Motor Corp. and C. Itoh & Co., Ltd.

Although KDD's two competitors are running in the red (hardly surprising since start-up costs are astronomical), they are confident of turning a profit within a few years. KDD probably will continue to dominate the market even though MPT's regulations call for KDD rates to be about 23 percent higher than those of its rivals. MPT has allowed KDD to cut its rates, however, translating into gains for consumers.

Financial Results - As Table 2 shows, KDD's net profits fluctuated even as its operating revenues grew steadily, at least until FY 1989. The villain appears to be the healthy growth of operating expenses, which outpaced the increase in operating revenues for three of the past five years. KDD's management cited sharply rising costs for marketing, customer service, equipment and research as the main causes of FY 1989's meager results. Management also claimed that the relatively flat sales in the April 1989-March 1990 period stemmed from a loss of customers to ITJ and IDC.

Its mediocre profit picture has not prevented KDD from improving its balance sheet. Thanks to skyrocketing land prices and rising equity markets, KDD's investment portfolio looks solid. Portfolio growth could be more impressive if KDD engaged in active investment strategies, but MPT's control over the company's annual business plans leaves little freedom to do so. Nevertheless, management has controlled the growth of liabilities, leading to a steady increase in shareholders' equity. Clearly in sound shape, KDD appears lackluster only in comparison with the record earnings growth of private-sector firms in the past few years.

Current Challenges - KDD's operating venue is uncomplicated relative to NTT's. Because KDD provides a relatively narrow range of services and because certain international telecommunications organizations (Intelsat, Inmarasat and the International Telecommunications Union, for example) require that one organization be appointed as a country's national representative, there has been no discussion of breaking up KDD. Its most likely prospects are to remain a special private corporation because intimate links with MPT are necessary to deal with international telecommunications issues. This setup, however, is nowhere near that of the days prior to the April 1985 deregulation of Japan's communications markets since the amendments to the KDD law were successful to a degree in giving the company greater freedom to respond to new competition.

KDD's biggest challenge is to get a firm grip on costs. Close ties to MPT appear to have dulled KDD's competitive spirit. Management is trying to instill a sense of urgency among its workers. Always present in the background, however, is the perception that MPT will never allow KDD to fail. Overcoming this complacency is a major task.

Future Plans - Like NTT, KDD plans to meet the challenges ahead by improving its core operations and adding subsidiaries where appropriate. KDD's basic goal is "to provide a full range of responsive and reliable end-to-end international telecommunications services." By tailoring services to the specific needs of clients, providing easier billing and payment methods (credit card calls are now possible, for example), KDD is trying to keep existing corporate and individual customers. Among its new offerings are a group of packaged services for corporate users. PLANS (Private-Link Advanced Network Support) offers everything from consulting services to complete turnkey systems. Other new services include ISDN for overseas links plus specialized facsimile and data transmission services. Investment in new transmitters and receivers also is taking a large chunk of KDD's budget. New undersea fiber-optic cables and better onshore distribution networks are aimed at improving the quality and the availability of KDD's international services.

Developing and introducing new technologies is KDD's second key to improving its core operations. The organization is preparing equipment to handle

Table 2: Financial Summary for Kokusai Denshin Denwa Co., Ltd., FY 1985-FY 1989

(in millions of yen for the years beginning April 1)

	FY 1985	FY 1986	FY 1987	FY 1988	FY 1989
Operating Revenues	Y216,066	Y223,987	Y248,460	Y258,346	Y258,719
Telephone	142,327	158,641	190,089	202,568	203,573
Other	73,739	65,345	58,370	55,778	55,146
Operating Expenses	179,610	192,959	207,468	215,264	226,920
Traffic and Commercial	44,551	48,522	52,741	53,935	57,830
Maintenance	24,802	28,007	29,252	28,554	29,132
Administration	35,350	33,619	34,973	36,794	34,079
Research and Development	4,916	4,595	4,802	4,942	4,708
Depreciation	35,226	39,529	41,245	42,969	46,083
Domestic Network Charges	33,561	35,729	39,632	44,683	50,608
Other	1,201	2,956	4,819	3,384	4,477
Operating Income	36,455	31,027	40,991	43,081	31,798
Nonoperating Revenues	6,933	15,203	13,170	16,571	11,397
Nonoperating Expenses	-2,662	-11,520	-9,233	-4,995	-5,897
Nonoperating Income	4,271	3,683	3,937	11,576	5,500
Income Before Taxes	40,725	34,709	44,927	54,657	37,297
Taxes	23,570	22,687	29,609	32,481	23,159
Net Income	17,155	12,022	15,318	22,176	14,138
Total Assets	364,489	430,860	466,944	461,041	489,785
Property and Investments	270,738	300,077	326,380	319,883	332,901
Current Assets	93,751	130,782	140,563	141,158	156,883
Liabilities and Shareholders' Equity	364,489	430,860	466,944	461,041	489,785
Fixed Liabilities	81,995	142,658	156,183	134,931	137,946
Current Liabilities	56,676	53,223	62,625	58,748	73,574
Shareholders' Equity	225,817	234,978	248,135	267,362	278,264

Source: Kokusai Denshin Denwa Co., Ltd., Annual Report 1990.

international transmission of high-definition television signals and is working on improving long-distance fiber-optic transmission systems. International video conferencing, improved satellite systems and computerized network management systems also are coming to market from KDD's research laboratories.

A very conservative approach marks KDD's diversification agenda; top priority is given to those ventures that will help KDD's core businesses. There is room for operations aimed at improving the bottom line, however. Initial attempts to branch out were timid. Telecomet International Inc. was founded in 1984 to peddle KDD's international telecommunications expertise at home and abroad. TELEHOUSE International Corp. of America and TELEHOUSE International Corp. of Europe, Ltd. were formed to lease space to house and provide support services for private international communications equipment (aimed at the needs of Japanese firms expanding overseas). Other examples of supporting subsidiaries are VIDEOCOM International Corp., KDD Teleserve Inc. and KDD Academy Inc. (The latter two provide language translation and training services.)

Newer ventures include Kokusai Information Service Co., Ltd., which markets Japanese and foreign data base services; OSI Plus Corp., which develops software based on the Open Systems Interconnect standard; and KDD Technology Corp., which seeks to spin off products and services from KDD's telecommunications and information processing technologies. Kokusai Marine Engineering Corp., which conducts marine surveys for submarine cables and other projects, and KDD Development Corp., which develops KDD's real estate assets, are two examples of subsidiaries geared to noncore activities.

JAL: Free to Fly or Fall

Commercial aviation is an area where free market principles usually have been subordinated to the interests of national security or sovereignty. The rigid bulwarks of national interests stand out with particular clarity in international aviation agreements. Postwar Japan developed an airline system similar to many European countries: a single international carrier and several domestic carriers. The American experience with airline deregulation in the early 1980s modeled the benefits and the risks of introducing free market mechanisms. As American carriers increased competitive pressures (thanks to deregulation's spread to international service) and the European Community's impending unification impelled continental airline companies to form alliances and/or merge, Tokyo began to scramble to restructure its airline industry.

Competitive Environment - Japan Airlines, as it now is called, was the nation's sole scheduled international carrier until halfway through the 1980s. The Minister of Finance held 49 percent of the stock at JAL's founding in 1951 as a special private corporation; the rest was sold to Japanese nationals. Private firms -- All Nippon Airways Co., Ltd. and Japan Air System Co., Ltd. (previously known as Toa Domestic Airlines) -- were allowed to carve up the domestic market. International passenger competition between JAL and the two domestic carriers was limited to unscheduled charter flights to a handful of foreign countries and domestic segments of JAL's international routes. In addition, cargo carriers were restricted to domestic service.

This cozy situation changed in May 1985 when Japan and the United States concluded an interim package of amendments to the 1952 bilateral civil aviation accord. (See JEI Report No. 13A, April 1, 1988 for a full discussion of bilateral civil aviation issues.) Not only did the accord break JAL's monopoly on international cargo service (Nippon Cargo Airlines Co., Ltd. was given transpacific rights), but it also opened the door for ANA and JAS to begin scheduled international passenger service. The pact also increased the number of foreign competitors in both the passenger and the cargo segments of Japan's aviation market. Faced with what amounted to a fait accompli, the Diet voted in September 1987 to abolish the Japan Air Lines Co., Ltd. Law, which was scheduled to expire in any case in mid-November 1988. The government sold its then 34.5 percent share of JAL in November 1987 for Y664.5 billion ($4.4 billion). JAL is not entirely free of the government's sway, however. A replacement JAL law went into effect as the old law expired. While the new firm has complete control over its internal structure, its annual operating plans still must be approved by the Ministry of Transportation.

The level of competition in domestic and international service has increased sharply since 1985. JAL now goes head-to-head with ANA and JAS on most domestic routes. JAS returns the compliment to many Asian destinations, and ANA is building its routes to the United States and Europe. At least seven American companies battle JAL for the booming transpacific passenger and cargo business; numerous other foreign carriers vie for rights to serve Japan. With its large fleet of planes and well-established network of overseas offices, JAL is in no danger of being overwhelmed. The issue is whether it can prosper.

Financial Results - On a nonconsolidated basis JAL has bounced back from the losses suffered in FY 1985 and FY 1986 because of depressed passenger revenues. Operating revenues rose 13.3 percent in FY 1989 to just under Y1.1 trillion ($7.1 billion), but the growth in net profits faltered, slipping 4.4 percent to under Y16.6 billion ($10.5 million). The picture on a consolidated basis (Table 3) is similar, although data for FY 1989 are lacking.

Passenger and cargo revenues have risen in line with the economy's current expansion, which started in 1986. Tokyo's promotion of consumer spending and the growing affluence of the average citizen have generated a boom in overseas tourism. Exports (and more recently imports) of high-value/small-size items, especially semiconductors, and perishable goods have kept cargo bays full. Less volatile exchange rates also have helped the bottom line. The transition to an entirely private enterprise in the FY 1987-FY 1989 period was conducted smoothly, with immediate consequences for some line items. Sales and advertising expenditures, for example, rose strongly in FY 1988, as did funding for new equipment. Most interesting is the surge in financial investments; the new JAL has both the freedom and the willingness to squeeze a higher return out of all its assets.

Current Challenges - Despite this relatively rosy picture, JAL's management faces several difficult tasks. In common with the other ex-public companies, labor issues are a problem. Outsiders criticize JAL for having too many people in management and administration and not enough pilots, flight attendants and ground crews. Foreigners make up an important part of JAL's flight crews, particularly as pilots. JAL is responding with improved training programs, but service expansion is likely to outpace the supply of pilots for some time.

Table 3: Financial Summary for Japan Airlines Co., Ltd., FY 1985-FY 1989

(in millions of yen for the years beginning April 1)

	Consolidated				Unconsolidated	
	FY 1985	FY 1986	FY 1987	FY 1988	FY 1988	FY 1989
Operating Revenues	Y924,808	Y875,716	Y972,070	Y1,091,568	Y935,746	Y1,060,315
Passenger	625,062	605,179	671,636	753,708	700,014	793,413
Domestic	156,227	157,979	187,949	211,661	196,227	227,891
International	468,835	447,200	483,687	542,047	503,787	565,522
Cargo	185,330	162,729	166,095	169,531	159,921	161,287
Domestic	18,953	20,292	23,070	25,539	20,768	20,294
International	166,377	142,437	143,025	143,992	139,153	140,993
Other	114,414	107,806	134,337	168,297	75,809	105,615
Operating Expenses	896,981	835,722	904,650	1,005,417	862,982	986,313
Flight Operations	543,177	522,022	559,760	592,467	677,432	769,453
Sales and Other Costs	353,804	313,700	344,890	412,950	185,550	216,860
Operating Income	27,286	39,994	67,419	86,150	72,763	74,002
Nonoperating Revenues	8,057	6,917	7,929	12,060	10,775	25,607
Nonoperating Expenses	-38,207	-42,785	-37,828	-46,148	-40,662	-46,863
Nonoperating Income	-30,151	-35,868	-29,899	-34,088	-29,888	-21,256
Income Before Taxes	-2,324	4,125	37,520	52,061	42,875	50,820
Income Taxes	2,278	12,000	18,526	32,590	25,545	29,124
Net Income	-4,088	-7,480	19,442	20,183	17,330	16,573
Total Assets	865,507	970,609	1,060,268	1,217,054	--	--
Current Assets	251,619	282,660	321,345	443,532	--	--
Fixed Assets	493,681	561,563	597,428	588,637	--	--
Other Assets	120,205	126,382	141,492	184,883	--	--
Liabilities and Shareholders' Equity	865,507	970,609	1,060,268	1,217,054	--	--
Current Liabilities	316,359	355,101	350,888	380,950	--	--
Long-Term Liabilities	342,215	411,676	480,653	486,840	--	--
Other Liabilities	64,743	69,000	74,019	80,376	--	--
Shareholders' Equity	142,189	134,830	154,706	268,886	--	--

Source: Japan Airlines Co., Ltd., Annual Report, 1987, 1989, 1990.

At headquarters JAL has tried to reshuffle management to end internal divisions and infighting. During JAL's long and intimate relationship with the government, factions mirroring various bureaucratic interests within the Ministry of Transportation developed and came into conflict with groups representing other interests. A June 1989 reorganization of the board of directors and subsequent personnel shifts, targeted at reducing MOT's influence on JAL, have yet to make a clear difference regarding internal strife. Many airline analysts have questioned whether the shift simply indicated that one faction had gained the upper hand for the moment. While everyone agrees that infighting wastes energy and prevents JAL from reacting quickly to new demands, no one has an immediate solution.

Another challenge is to repair a corporate image tarnished by the 1985 crash of a jumbo jet on a domestic flight. Although a faulty bulkhead repair made by Boeing Co. employees was determined to be a cause of the crash, JAL's reputation for safety was damaged. Management responded with programs and advertising that put safety above all else, even profits. While passenger loads have returned to satisfactory levels, JAL knows that it cannot relax its vigilance in this area.

Future Plans - JAL's late 1987 rebirth as a fully private firm set the airline on new paths and recommitted it to traditional goals. Investment in a state-of-the-art fleet of aircraft is seen as a sharp weapon in the intensifying battle to gain passengers and keep operating costs down. For example, JAL -- already operating the world's largest fleet of Boeing 747's -- has firm orders for 40 of the current-generation 747-400 series, which needs only a two-person cockpit crew and offers a 10 percent-plus improvement in fuel efficiency over the 747-300 model. In addition, JAL has placed firm orders for 10 of the MD-11 transport made by McDonnell Douglas Corp.

Better ground equipment also forms an important part of JAL's strategy. New maintenance and repair facilities not only will keep its fleet in top shape but may help win a share of maintenance contracts from other airlines. JAL also is investing in automating many labor-intensive maintenance and repair operations. A new $8 million washing device allows a four-person crew to clean a 747 jet in an hour, an operation that done manually requires many more workers and several hours; a specially designed vehicle has cut the number of service personnel needed to replace an aircraft wheel from three to one; and a robot window polisher eliminates the costly process of removing scratched windows for replacement.

JAL's AXESS computer reservation system is the most visible part of the firm's Y130 billion ($866.7 million) medium-term plan to develop advanced software and hardware systems to provide better service to customers. In cooperation with American Airlines, JAL is working on better transaction-processing software for reservations systems.

Among the former public service corporations JAL has the most aggressive diversification plans. Management has set of goal a raising revenues from diversified operations to 50 percent of the parent corporation's revenues by FY 1992. JAL has 17 consolidated subsidiaries (five of which are wholly owned) and a minority interest in another 144 companies. Of special interest to JAL is the hotel and leisure industry, which complements its core operations. JAL is not afraid of ranging far afield from the travel industry, however. It is opening a chain of Western-style restaurants in Japan and is launching its own brand of uniforms for Japanese grade schoolers in cooperation with designers in London, Paris, Milan, Madrid and New York. Although many ventures are intended to fatten profits, others are aimed at giving employees managerial experience as well as providing a place for excess employees.

Most interesting, internationalization has spread to JAL's financing operations. The company has made active use of the Euromarket for straight and warrant bonds; it also taps the commercial paper market in Japan. In addition, JAL has opened financial subsidiaries to help JAL group firms obtain better financing. It is actively restructuring its long-term debt to cut interest costs and is seeking to maximize return on all its financial assets.

Japan Tobacco: Trying Not to Get Burnt

Although government monopolization of the production and the distribution of tobacco products seems odd to Americans, it is a common feature in Asia. While American cigarette makers long had been interested in Japan's market, that country's growing bilateral trade surplus with the United States brought a new intensity to American demands for access. After sometimes acrimonious talks dating back to the mid-1970s, the Diet passed legislation in the summer of 1984 restructuring Japan Tobacco and Salt into what became Japan Tobacco in April 1985. On the same date, Tokyo opened the import and wholesale business to foreign and domestic firms alike. Restrictions on sales outlets for foreign products essentially were eliminated as well. The pricing formula for imported cigarettes also was changed in April 1985 in response to foreign complaints that imported products were treated unfairly, and two years later the tariff on cigarettes was scrapped. JTI retains a monopoly on the production of tobacco products in Japan, but foreign cigarettes have steadily chipped away at its market share -- in part because JTI is required to buy all domestically grown leaf, much of it low quality.

The salt business emerged unchanged from the April 1985 JTS restructuring; salt production remains a government monopoly. And, while JTI lost the reference to salt in its name, it still must obtain the Ministry of Finance's approval for all salt-related business plans and operations.

Competitive Environment - Unlike the other ex-public corporations, JTI faces a stagnant market. Total cigarette sales were up less than 2 percent in FY 1989 to about 320 billion pieces. An increase in the number of female smokers is expected to counter much of the projected decrease in smoking by men. With little change in the overall size of the market, foreign sales are taking their gains out of JTI's hide.

Three foreign firms have made the biggest inroads into Japan's cigarette market. Phillip Morris Inc. (which sells Lark, Parliament and Merit brands) led the pack with an estimated 8.3 percent market share in FY 1989, followed by Brown & Williamson Tobacco Corp. (maker of Kent and Lucky Strike brands) at 3 percent and R.J. Reynolds Tobacco Co./M.C. Tobacco Co. (Vantage brand) at 1.9 percent. With all other imports accounting for about 1 percent of the market, foreign brands made up about 14 percent of overall consumption in the April 1989-March 1990 period. Observers predict that this share will rise to 20 percent within a few years.

Nevertheless, JTI's dominant market position is likely to persist for the foreseeable future. Its Mild Seven family of products continues to account for more than 40 percent of all cigarette sales in Japan. Combined with its other domestic brands -- Cabin, Caster, Seven Stars and SomeTime -- and foreign-licensed brands -- Marlboro, Peace, Frontier, Hi-Lite and Hope -- JTI commanded a little less than 86 percent of the Japanese market in FY 1989. The only foreign product to make the list of 10 best-selling cigarette brands was Lark Milds in tenth place.

Financial Results - JTI has posted mixed results over the past several years (Table 4). Earnings have been drifting lower for several years, while outlays for sales and marketing have been rising. Profits from diversified operations still are too tiny to affect the bottom line, yet JTI plans to sink more money into other new ventures. Management admits that the profit picture is not bright but contends that the firm should be in the black over the long run.

Table 4: Nonconsolidated Financial Summary for Japan Tobacco Inc., FY 1982 and FY 1987-FY 1988

(in billions of yen for the years beginning April 1)

	FY 1982	FY 1987	FY 1988
Net Sales	Y2,815	Y2,798	Y2,724
Tobacco and New Businesses	2,722	2,727	2,654
Salt	93	71	70
Cost of Sales	2,544	2,453	2,366
Cost of Goods Sold	759	660	630
Tobacco Excise Taxes	778	1,794	1,735
Transfer to National Treasury	1,007	--	--
Gross Profit	271	345	358
Selling, General and Administrative Expenses	184	231	254
Operating Profit	87	114	105
Nonoperating Income (Expenses)	6	8	-20
Income Before Taxes	93	122	85
Income Taxes	--	85	47
Net Income	93	37	38

Sources: Japan Tobacco & Salt Public Corp., Annual Report 1984, and Japan Tobacco Inc., Annual Report 1989.

Current Challenges - JTI finds itself in the awkward position of promoting to an increasingly health-conscious public a product that significantly increases the likelihood of certain diseases. By restricting advertising and requiring stronger health warnings on tobacco products, the government is not making sales easier. Finding a solution to this paradox is a major concern of management.

Responding to the challenge of imported brands also occupies planners at JTI. New products, lower production costs and increased emphasis on exports are being juggled in an attempt to hold the line against foreign cigarettes. Given that JTI must use inferior domestic leaf (which it blends with leaf purchased overseas) and the cachet of foreign brands, which domestic brands cannot match, a 20 percent foreign market share projection seems conservative.

Export market development also poses some tough questions. Antismoking sentiment in advanced and developing countries is gaining strength, threatening ambitious expansion plans. While the Eastern European and the Soviet markets are attracting interest from American and Western European tobacco firms, JTI has yet to make a move into these potentially lucrative areas.

Future Plans - JTI cannot abandon its core tobacco business and is pouring money into more efficient production equipment and product development. It also is trying to improve the quality of domestic leaf through biotechnology. These core operations have spawned a number of promising business lines, including manufacturing consulting, machine engineering services and a line of agricultural products, such as seeds, fertilizers and pesticides. JTI also pins much hope on its prescription and over-the-counter pharmaceuticals business.

To counter its unhealthy image JTI is expanding into the health improvement industry. It has opened a chain of health clubs and introduced a line of health and sport drinks. JTI's HalfTime beverages also boast several products that feature herb-derived flavorings. Food products appealing to the health conscious are another avenue of diversification. JTI has ventures in the mushroom business (Fuji BioFarm Corp.), a noodle and processed meat maker (JT Agris Corp.) and a joint restaurant venture (Chicago Foods Corp.)

Japan Railways: Working Out From Under a Mountain of Debt

The Japanese National Railways' reputation for excellent service is well justified. While state-of-the-art high-speed bullet trains (*shinkansen*) are Japan's pride, the frequency and punctuality of its regular train service is the heart of the system. Despite this operating efficiency, JNR was in disastrous financial shape at the start of the 1980s; its cost structure was way out of line in comparison with private competitors. In the final two years before its April 1987 restructuring JNR lost more than Y3.2 trillion ($21.3 billion), bringing its total short-term debt to Y14.1 trillion ($94 billion) and its long-term debt to Y23.6 trillion ($157.3 billion). It is not hard to understand why the government wanted to uncouple itself from JNR and why it took time to develop a reorganization plan that would have a good chance of success. A government commission studied the situation for two years and found a host of problems: JNR was overregulated, uncompetitive, unresponsive, too big and plagued by poor labor-management relations.

Adopting the commission's recommendations without change, JNR became the Japan Railways Group: six passenger lines -- East Japan Railway Co., Ltd., Central Japan Railway Co., Ltd., West Japan Railway Co., Ltd., Shikoku Railway Co., Ltd., Kyushu Railway Co., Ltd. and Hokkaido Railway Co., Ltd.; a freight company (Japan Freight Railway Co., Ltd.); a firm to lease bullet trains to the passenger companies and to support new bullet train construction (Shinkansen Holding Corp.); a holding company to handle JNR's debts (JNR Settlement Corp.); and three new subsidiaries -- the Railway Technical Research Institute, Railway Telecommunication Co., Ltd. and Railway Information Systems Co., Ltd.

JNR's assets -- 200 rail lines, 13,000-plus miles of track, 45,500 rail cars (passenger and freight), 4,600 stations, 226 square miles of land and Y41.5 billion ($276.7 million) invested in 155 nonrail enterprises -- were divied up among the new companies. Employment by the new group was immediately cut by 61,000 to 215,000. Also divied up was JNR's short- and long-term debt: JNR Settlement took Y25.6 trillion ($170.7 billion), Shinkansen Holding shouldered Y5.7 trillion ($38 billion) and the remaining Y5.9 trillion ($39.3 billion) was spread among JR East, JR Central, JR West, Railway Telecommunication and Railway Information Systems. Although the six passenger rail companies now technically are private firms, the government is the only stockholder; this is expected to change in the near future.

Competitive Environment - In contrast to other public corporations that were privatized, JNR always had competition in the passenger market. The competition remains fierce. Private passenger railways have nearly an equal number of stations (4,949) and almost the same amount of rolling stock (22,057 cars) as JR. Yet they carry nearly two-thirds of all passenger traffic (12.6 billion) with half the employees (113,700). JR still faces stiff competition in urban markets but practically none in rural areas. Competitive pressures keep JR from raising fares in high-volume markets. At the same time it is unable to completely eliminate unprofitable rural routes. The competitive challenge has not changed; rather, JR has changed to meet the competition.

Financial Results - The reorganization has been a stunning success (see Table 5). All six passenger lines broke even in their first year of operation -- FY 1987; as a group they earned Y50 billion ($333.3 million) after taxes. In FY 1988 JR East and JR Central recorded net incomes of Y41.4 billion ($276 million) and Y35.2 billion ($234.7 million), respectively, and the six as a group showed a net profit of Y86.1 billion ($574 million). Results for FY 1989 indicated that JR East (net profits of Y66.7 billion or $444.7 million), JR Central (net income of Y57.2 billion or $381.3 million) and JR West (net profits of Y25.7 billion or $171.3 million) remained healthy. (Financial results for the other three companies were not available.) As a result, the three JR passenger rail companies that inherited JNR debt were able to reduce their share by Y468.3 billion ($3.1 billion) in FY 1988 to Y3.9 trillion ($26 billion) and, although data are not available, the debt probably was cut even more in FY 1989 as profits rose.

JR's freight business also is in the black, showing pretax income of Y4.6 billion ($30.7 million) in FY 1989, a gain of Y1.2 billion ($8 million) over the previous year. JNR Settlement is not expected to earn a profit but rather work down the mountain of debt inherited from JNR and any new debts from service expansions. So far, new debts have outpaced income from real estate sales and payments from other JR Group firms. Interest payments reportedly amount to some Y3 billion ($20 million) a day, and the total debt had crept up to Y37.5 trillion ($250 billion) as of the end of March 1990. Shinkansen Holding enjoys firm leasing revenues from the passenger companies but is piling up debt because of new construction projects. The nonrail JR members are likely to be in the red as they still are pouring money into start-up operations.

Current Challenges - Working down the inherited debt will remain a top priority for some time, but other factors could delay progress. For example, Tokyo has put pressure on JNR Settlement to slow or postpone the sale of properties to help cool the superheated real estate market. The profit-oriented passenger rail firms naturally will resist using their income to speed payments on the debt.

Table 5: Selected Data on Passenger Operations of Japanese National Railways and Japan Railways Group

(in units as indicated)

	JNR FY 1986	JR Group FY 1988
Operating Revenues (billions of yen)	Y3,027	Y3,717
Net Income (billions of yen)	Y-1,361	Y86
Passenger Line Network (kilometers at end of fiscal year)	21,194	20,933
Passenger-Kilometers (millions)*	198,299	204,678
Passengers (millions)*	7,104	7,356
Train-Kilometers (millions)*	549	552
Rolling Stock-Kilometers (millions)*	4,150	4,065
Stations (number at end of fiscal year)*	4,591	4,894

*JR Group data covers FY 1987.

Sources: Management and Coordination Agency, Japan Statistical Yearbook 1989, and East Japan Railway Co., Ltd., Fact Book 1989.

In addition, JR still must contend with the pork-barrel politics that lead to immensely expensive expansion into sparsely populated areas. The recently completed Seikan tunnel, which links the main island of Honshu with the northern island of Hokkaido, is a marvel of engineering; its cost was so high, however, that it never can be economical. Political pressure reaches even to research activities. A test track for a magnetically levitated and driven train will be built in the home district of a powerful politician and has ignited a land speculation frenzy there that has pumped up the cost of the project. It is unlikely that the JR Group will ever be free of political influence, a situation that threatens whatever gains private management makes.

Moves to pare JR's work force raise concerns not only with its labor unions but with the public as well. Approximately 2,600 workers cut in the 1987 reorganization have yet to be reemployed. Tiring of the nonproductive payroll expense, JNR Settlement issued dismissal notices to the laid-off staff, effective April 1, 1990. Labor unions and politicians were outraged since the action goes against several labor relations boards' rulings that the workers should be rehired by the new JR companies. Although the dispute is in mediation, it has besmirched the new JR and reignited labor tensions.

An emerging problem is the performance disparity between the passenger rail companies that serve the main island of Honshu -- JR East, JR Central and JR West -- and the firms that serve the smaller islands of Hokkaido, Kyushu and Shikoku. The disparity is not surprising since economic activity is centered between Tokyo and Hiroshima, an area served by all three Honshu JR firms. The volume of traffic on the smaller islands makes it unlikely that the companies serving these areas ever will be as healthy as the three mainland lines. Whether this will force another reorganization in the future is unclear.

Future Plans - The JR Group is committed to improving the quality of its service and equipment while cutting costs. New engines and specially designed cars that appeal to tourists is one area of intense development. Another is improvements to the shinkansen trains, increasing their energy efficiency, hauling capacity and speed from the current 150 miles per hour average. Computerized yard operations and signaling systems continue to be refined, while computerization of reservations, ticketing and information services proceeds. The jewel in the Railway Technical Research Institute's crown, however, is the experimental maglev train with projected top speeds of up to 325 mph. Bringing the prototype to commercial use is expected to cost at least $25 billion and take until the turn of the century.

The nonrail JR Group companies are the other weapons in the battle for profits. Because the cost of land in Japan is so high, Railway Telecommunication has an advantage over competitors if its railway ties enable it to lease more cheaply the right to lay communications cables along JR rights-of-way. The firm is busy laying a fiber-optic network and hopes to become a major player in the communications industry. Railway Information Systems certainly will be one of the fiber-optic network's first users, providing value-added processing services to other JR companies and outsiders. The JR passenger firms also are expanding into nonrail businesses, particularly into services located in railway stations. Fast-food outlets, sundry stores and newsstands are natural extensions for the rail companies and provide outlets for excess employees.

A key milestone in the group's attempt to evolve into truly private companies will be a successful stock offering to the public. Based on their profitable performances both JR East and JR Central are eligible to list their shares on the Tokyo Stock Exchange. JR West and Japan Freight Railway hope that their performance this year will bring them up to snuff. Analysts estimate that the first sale of JR East and JR Central stock, now scheduled for the fall of 1991, could bring in between Y9.4 trillion and Y12.5 trillion ($62.7 billion to $83.3 billion), welcome news to a Finance Ministry that is growing very concerned over JR Group's mounting debt load. JR and Ministry of Transportation officials now are engaged in discussions about how to avoid the NTT-syndrome of inflated stock price expectations.

Part of this strategy includes freeing each JR company from government oversight as it goes public. The JR Company Law presently requires each JR firm to obtain MOT approval of board member appointments, fund-raising operations and annual business plans. MOT had hoped to retain these powers until the government had sold all its JR Group shares. Tokyo Stock Exchange officials argued that each JR company must be freed from these onerous requirements when each is sold to the public to improve the attractiveness of the offer. MOT apparently has heeded the TSE's advice and announced in early August that the necessary amendments to the JR Company Law would be ready for the 1991 sale.

To address concerns about foreign influence over an important national asset, MOT will place 30 to 40 percent of any publicly offered shares in the hands of friendly, stable shareholders. Even if foreigners do gain a say in the management of a JR firm, MOT still has the power to regulate fares and service.

The Debate Continues

The privatization of public service corporations and the liberalization of markets they once monopolized have yielded clear benefits in the Japanese context. Consumers are enjoying lower prices and more choices for telephone service, air transportation and cigarettes. Market newcomers, both Japanese and foreign, have brought innovative services to consumers while turning a profit. The government has made significant progress toward its goal of spurring competition in these areas and freeing itself of the obligation to back money-losing operations.

Besides expanding foreign opportunities in Japan's markets, privatization and liberalization have had a positive effect on relations with trading partners by removing sources of tension. American tobacco companies, for example, are satisfied that the Japanese market no longer is closed to them. The same generally is true in the telecommunications and air transport markets, although flare-ups still are possible. In a more general sense the Japanese system of public service corporations is now closer to the American than the European model. While the similarities cannot be attributed to the wholesale adoption by Tokyo of American views on the role of government, it does indicate the differences between Washington and Tokyo on the subject of privatization are narrower than those between the United States and most European nations. Whether this leads to greater U.S.-Japan cooperation on related issues is unclear.

Although Japan's experience has been smoother than similar actions in America, the transition from government to private ownership has not been painless for the organizations involved or for the government and the consumer. Efforts by new management to reduce labor costs has been particularly painful to a nation that prides itself on social harmony. Japanese consumers have had to adjust to the new complexity of previously simple services, just as American consumers were bewildered by the breakup of AT&T. On balance, however, most Japanese would agree that the changes have been beneficial.

Whether privatization should be extended to the remaining government-owned corporations now is under discussion. Although privatization might yield improved efficiency, intimate ties to government are central to the functions of certain organizations, such as the Japan Development Bank and the Export-Import Bank of Japan. Other government companies by their nature are unprofitable and could not survive as private operations. Rural development agencies and some small business support organizations are examples of this group. For other government corporations, however, the shift to private status is a viable option. The government's housing loan business, the national hospital system and the postal savings system all have been floated as candidates for privatization. Tokyo's most likely approach will be to bide its time, monitoring the progress of the companies that already have been privatized with an eye toward applying the experience elsewhere. It does appear, however, that a permanent shift has taken place in Japanese attitudes toward the role of government in providing public services.

For further information, contact Jon Choy.

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The views expressed in this report are those of the author and do not necessarily represent those of the Japan Economic Institute.

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JEI

REPORT

A Two-Part Report: A and B

NO. 32B
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IN THIS ISSUE:

Economic White Paper Upbeat About Economy 1

Construction Issue Building Up Again 3

Japan Keeps Thumb On Rising Health-Care Costs ... 4

Second APEC Meeting Takes Small Steps Toward Solidifying Forum 8

Notes: Kaifu's Middle East Trip 9

Economic White Paper Upbeat About Economy

Every summer the Economic Planning Agency releases a white paper describing the performance of the Japanese economy over the past year and the prospects for the coming year. Themes in recent reports have become increasingly repetitive since Japan's economic expansion, which EPA identifies as having begun in late 1986, shows few signs of ending. EPA typically predicts the domestic-led expansion will continue, although it notes that protectionism abroad remains a threat. It adds that labor shortages are becoming a more serious problem, bringing with them the threat of inflation.

Every one of these themes, drawn from the 1989 report, reappeared in this year's edition. With the crisis in the Middle East coming too late for inclusion, EPA gave little attention to energy factors, thus forgoing an opportunity to rouse the attention of the Japanese public. (Subsequently, Shousuke Tanaka, director general of EPA's research bureau, indicated that the unrest in the Middle East would not necessarily have a major effect on the strength of the Japanese economy.)

Given this context, one would not normally expect this year's economic white paper to become a best seller, but such a view could be mistaken. Several

Japan Economic Institute 1000 Connecticut Avenue, N.W., Washington, D.C. 20036 202·296·5633

failure to win the contract could have a chilling effect on other foreign bidders, the Alaska Republican warned, especially in light of its solid credentials and expenditure of $1 million to prepare the bid.

The KIA decision also dimmed prospects for another American bid. Austin Co. of Cleveland and Kawasaki Heavy Industries, Ltd., considered by industry analysts a highly competitive team, joined to submit a bid for the airport's baggage-handling system. According to rumors in the Japanese press, a group led by Toyo Construction Co., Ltd., which includes Rapistan Co. and Portec Inc. of the United States, has the inside track on the $40 to $53 million contract. U.S. officials are pressing KIA to explain how it is handling the baggage system bids and what criteria it is using to evaluate them.

Undersecretary of Commerce for International Trade Michael Farren asked Tokyo to respond by August 13 to 11 questions about KIA's decision on the people-mover system. The gist of the Foreign Ministry's August 15 response was that the procedures outlined in the 1988 agreement that pertain to consulting services were followed in a transparent manner. The systems proposed by AEG Westinghouse and Niigata Engineering were similar in terms of quality and service but showed a large price differential. Finally, although Niigata Engineering does not have experience building airport people-mover systems, it has built many municipal transportation systems that are similar, according to the Foreign Ministry. At JEI press time the Commerce Department was examining the explanation and had not yet reacted.

After a period of relative calm, the latest KIA contract award has called into question Tokyo's commitment to the spirit and the letter of the 1988 accord, at least from Washington's viewpoint. Although the Ministry of Construction, the Fair Trade Commission and Japanese construction industry associations all have taken steps to allay foreign concerns, these measures appear to be insufficient. The Japanese press continues to carry stories about bid collusion and rumors of price-fixing in the construction industry. In light of Tokyo's commitment in the final report on the Structural Impediments Initiative talks to raise spending on infrastructure, U.S. pressure to ensure that foreign firms get a fair crack at Japan's public works market will only increase.

Jon Choy

Japan Keeps Thumb On Rising Health-Care Costs

Three abnormal occurrences helped Japan keep health-care disbursements from growing faster than gross national product in the fiscal year that ended March 31, 1989. The Y679.5 billion ($4.5 billion at Y150=$1.00) rise in national health expenditures that year to nearly Y18.8 trillion ($125 billion) amounted to only a 3.8 percent increase, while GNP in FY 1988 rose at a nominal rate of 6 percent. Shaving an estimated 0.7 percentage point off the increase were a national day of mourning, a new holiday and a statistical windfall that results every year after leap year. A July report by the Ministry of Health and Welfare credited these factors with helping hold the hike in health-care costs below nominal GNP growth for the first time since FY 1984.

In a nation that provides nearly universal health-care insurance coverage, even chance elements get credit for helping contain costs. The death of the Showa Emperor in January 1989 resulted in his February funeral being declared a national holiday. While those already hospitalized were unaffected, one less day of medical service at private and public hospitals and clinics had an apparent impact on the health-care system. (Whether the emperor's months-long illness and heavy media coverage had a ripple effect in inspiring others to seek additional medical consultations was not mentioned.) The other two factors were the first celebration of a new May 4 holiday and FY 1988 statistics being compared to a leap year with its extra day of service possibilities. These aberrations, however, are less significant for the long term than efforts made to more strictly monitor billing and service to make sure that expenditures are appropriate.

Findings of improper billing (and insurers' subsequent refusal to pay) might be expected either to increase the patient's out-of-pocket payment or cut into the health-care provider's revenues. No figures are available for the latter option, but out-of-pocket expenditures increased only about 3 percent in FY 1988 and actually made up slightly less of the overall contribution (12.4 percent) than they did in FY 1987 (12.5 percent). The government's outlays for its mix of public and old-age assistance rose only about 2.4 percent, while payments from insurance associations (to which employers and employees both contribute) increased 4.7 percent.

The 12.4 percent of the total health-care bill covered by patients (see Tables 1 and 2) contrasts with the 21 percent paid out-of-pocket by Americans (Table 3), although the two health-care systems cannot be compared directly. Insurance coverage remains essentially voluntary in the United States -- with those not insured either tapping their own or government resources, while the Japanese system involves obligatory insurance coverage of some type plus copayments. (For more details on Japan's health insurance system, see JEI Report No. 16A, April 21, 1989.) Out-of-pocket outlays in both countries refer to copayments and independent expenditures but not mandatory contributions to health-insurance schemes. Given the different health-care systems and the obligations of each government, American policymakers might be surprised to see that both federal and state governments appear to pay a larger part of the overall health-care bill (42.1 percent) than does the Japanese government.

Table 1: Japan's Health-Care Receipts by Source of Funds, FY 1988

(in trillions of yen and billions of dollars*)

	Amount		Percent
	Yen	Dollars	of Total
Government	Y5.85	$45.6	31.2%
Insurance System**	10.53	82.1	56.2
Patient Out-of-Pocket	2.32	18.1	12.4
Other	0.05	0.4	0.2
Total Receipts	18.76	146.2	100.0

*Converted at FY 1988's average exchange rate of Y128.26= $1.00.

**Includes company and employee contributions.

Source: Ministry of Health and Welfare, July 1990.

Table 2: Japan's Health-Care Outlays by Type of Program, FY 1988

(in billions of yen and millions of dollars*)

	Amount		Percent
	Yen	Dollars	of Total
Public Assistance	$1,110.1	$8,655.1	5.9%
Insurance Systems	10,327.9	80,523.2	55.1
Medical Insurance	9,979.0	77,802.9	53.2
Salaried Plan**	6,006.0	46,826.8	32.0
Employees	3,417.2	26,642.8	18.2
Dependents	2,588.8	20,184.0	13.8
Self-Insured Plan	3,973.0	30,976.1	21.2
Other***	348.9	2,720.3	1.9
Old-Age Insurance	5,000.2	38,984.9	26.7
Patient Expenses****	2,317.3	18,067.2	12.4
Patient Out-of-Pocket	347.9	2,712.5	1.9
Total Outlays	18,755.4	146,229.5	100.0

*Converted at FY 1988's average exchange rate of Y128.26= $1.00.

**Includes public employees, teachers in both public and private schools, seamen under the seamen's insurance portion and municipal and other local government employees.

***Includes worker's compensation.

****Includes out-of-pocket expenses as well as payments made by any private insurance plan or other assistance not listed above.

Source: Ministry of Health and Welfare, July 1990.

Table 3: U.S. Health Outlays by Source of Funds and Type of Service, 1988

(in billions of dollars)

	Private			Government			
	Total	Patient	Private Insurer	Total	Federal	State/ Local	Total
Hospital Care	$96.6	$11.3	$75.0	$115.2	$86.7	$28.5	$211.8
Physician Care	70.0	19.9	50.0	35.2	28.7	6.4	105.1
Dental Services	28.7	16.3	12.4	0.7	0.4	0.3	29.4
Drugs and Related Nondurables	37.3	29.6	7.7	4.6	2.2	2.4	41.9
Nursing Home Care*	22.1	20.8	0.5	20.9	12.5	8.4	43.1
Total Outlays	312.4	113.2	174.9	227.5	157.8	69.6	539.9

*Includes other private-fund payments in the total from philanthropic or other sources.

Source: Office of National Cost Estimates, Health Care Financing Administration.

Both countries, however, face considerable future strain as those older than 65 make up a bigger portion of their populations. The health costs of this segment of society falls harder on government in Japan, perhaps, than in the United States, where supplemental insurance policies and copayment take some of the burden off of Medicare (the government-sponsored program on which U.S. elderly rely). Moreover, per capita health expenditures in Japan for those over age 65 are more than three-and-a-half times the average for all ages, whereas in the United States the bill for those 65 and up was not quite double the average for all ages (see Table 4). In addition, health costs in Japan for those aged 70 and over rose at a rate of 6.2 percent in FY 1988, considered a portent for the future. A government plan to cut back on long hospital stays, attributed primarily to the elderly, has meant the funding of new intermediate care institutions. In FY 1988 Tokyo spent Y3.5 billion ($23.3 million) on these facilities, a fraction of its overall outlays (see Table 5) but one deemed worth

Table 4: Per Capita Health-Care Expenditures in United States and Japan

(calendar 1988 for the United States, fiscal 1988 for Japan)

	United States			Japan		
		Insurance Premiums				
	Total	Private Insurance	Medicare	Yen	Dollars*	Percent of Total
All Ages	$1,298	$397	$77	Y133,600	$1,042	100.0%
Under 65	1,089	355	13	284,300	2,217	60.4
65 and Up	2,099	559	323	471,400	3,675	39.6
Over 70	n.a.	n.a.	n.a.	556,300	4,337	31.1

*Converted at FY 1988's average exchange rate of Y128.26=$1.00.

Sources: Office of National Cost Estimates, Health Care Financing Administration and Ministry of Health and Welfare

Table 5: Selected Japanese Health-Care Outlays, FY 1985-FY 1988

(in billions of yen)

	FY 1985	FY 1986	FY 1987	FY 1988
Inpatients	Y7,083.3	Y7,483.8	Y7,810.9	Y7,979.7
General Hospital	6,505.4	6,908.9	7,257.8	7,445.9
General Clinic	577.8	574.9	553.0	533.7
Outpatients	6,945.4	7,437.1	8,005.5	8,419.9
General Hospital	2,703.7	2,918.7	3,396.4	3,648.6
General Clinic	4,241.7	4,518.4	4,609.1	4,771.4
Prescriptions Filled by Drugstores*	309.4	348.5	394.2	425.6
Dental Care	1,677.8	1,799.6	1,865.3	1,926.8
Intermediate Institutional Care for the Elderly				3.5

*Most prescriptions are written and filled within clinics or hospitals and not by freestanding drugstores.

Source: Ministry of Health and Welfare

the initial cost if it succeeds in decreasing use of the more expensive hospitals for simple rehabilitation therapy and custodial care.

Whether lessons can be learned from the Japanese health-care system and applied in the United States, where national health-care expenditures climbed 10.4 percent in 1988 to a total of $539.9 billion, depends on how willing Washington may be to mandate health insurance to spread costs among more employers. Conversely, Tokyo may be interested in pushing harder for cost controls on medical care sought by those over 65, particularly given Japan's status as the nation with the highest longevity rates.

Pat Murdo

Second APEC Meeting Takes Small Steps Toward Solidifying Forum

The second meeting of the Asia Pacific Economic Cooperation conference -- 12 Pacific Rim nations that hope to boost regional economic cooperation -- broached organizational questions that had been avoided during the APEC founding conference a little less than a year ago. The July 30-31 gathering in Singapore addressed, but did not formally act on, membership for China, Taiwan and Hong Kong. Inclusion of the three economies was questioned in the initial APEC meeting. While there was some feeling that only market economies should be included in the grouping, there also were concerns that excluding China while admitting Hong Kong and Taiwan might intensify political frictions. APEC as set up in November 1989 includes Japan, the United States, Canada, South Korea, Australia and New Zealand as well as the members of the Association of Southeast Asian Nations -- Singapore, Malaysia, Indonesia, Thailand, Brunei and the Philippines.

Although the forum sidestepped concrete proposals for including China, Taiwan and Hong Kong, which were acknowledged as playing a significant economic role in the region, it was agreed that consultations should proceed to arrange their concurrent participation in APEC. Foreign Minister Taro Nakayama told the conference, "The real potential value of APEC cannot be realized without the participation of these three economies." It remains to be seen if terms can be reached that will be acceptable to all three; China's Foreign Minister Qian Qichen reportedly has said that Beijing would not object to the inclusion of Hong Kong or Taiwan as long as they were not given the same sovereign status as China.

Some of the issues raised in Singapore echoed those of the first meeting in Canberra; that first gathering stemmed from proposals for a Pacific regional economic grouping advanced separately in 1989 by Australian Prime Minister Bob Hawke and Secretary of State James Baker. (For details on the first APEC meeting see JEI Reports No. 43B, November 10, 1989, and No. 44A, November 17, 1989.) Although a communique issued on conclusion of the July meeting noted that the enhancement of APEC would complement and strengthen the Association of Southeast Asian Nations, some Asean members have cautioned that their organization's proven regional influence could be diluted by a new Asian Pacific economic body, particularly given the inclusion of the world's two largest economies, the United States and Japan. Speaking on the eve of the meeting's opening, Singapore Prime Minister Lee Kuan Yew described Asean and APEC as "concentric circles of cooperation, which can progress together." APEC participants

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REPORT

A Two-Part Report: A and B

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OIL PRICES AND THE JAPANESE ECONOMY

Summary

Oil supply disruptions and price increases in the 1970s are seared on the memory of Japanese old enough to remember. The first oil shock in 1973 and 1974, in particular, seemed to embody a terrible nightmare of a small, resource-poor island nation cut off from essential industrial inputs. While that perception of Japan's vulnerability by no means has disappeared, both government officials and Japanese consumers, although worried about the prospect of war, have displayed surprising nonchalance at the prospect of substantially higher oil prices in the wake of the Iraqi invasion of Kuwait. While the best evidence is that Japan is less vulnerable than at the time of the two oil shocks of the 1970s, price increases matching those in the previous crises would have a measurable adverse effect on the economy. However, its current self-confidence puts Tokyo in a better economic and political position to join in international actions that could make such a run-up in oil prices less likely.

Japan's Dependence on Oil

As a modern industrial country Japan uses prodigious amounts of oil. Daily imports averaged 5 million barrels in 1989, a figure exceeded only by the United States, which imported 7.2 million barrels a day. In terms of use the Department of Energy reports that for 1987, the most recent year for which complete data are available, Japan accounted for 7.1 percent of world oil consumption against 26.9 percent for the United States. By this measure the Soviet

Union ranked second, using 14.3 percent.[1] But unlike the United States, which produces about half the oil it uses, or the Soviet Union, which is an exporter, Japan depended on foreign sources for 99.7 percent of its oil supplies in 1989.

By many measures, however, Japan's vulnerability to an oil cutoff or significantly higher oil prices has fallen dramatically in recent years. Although crude oil imports increased 6.6 percent in 1989, according to Ministry of Finance data, they still were 19.4 percent below the level of 1980 (see Table 1). A volume of oil imports lower than that of nearly a decade earlier is a substantial accomplishment given population growth and substantial increases in gross national product over this same period. The Bank of Japan has calculated that Japan used 27.5 percent less oil per unit of real GNP in 1985 than in 1980 and 4.9 percent less in 1989 than in 1985. The United States, in comparison, used 18.5 percent less over the earlier period and 4.2 percent less over the latter.[2] In other words, both the United States and Japan apparently have made substantial strides in conservation, with Japan doing significantly better early in the decade.

Table 1: Japan's Imports of Crude Oil, 1980-89

	Volume (millions of barrels)	Value (billions of dollars)	Dollars per Barrel	Yen per Kiloliter
1980	1,600	$52.8	$32.97	Y47,197
1981	1,431	53.3	37.29	51,387
1982	1,335	46.3	34.66	53,906
1983	1,302	40.1	30.77	45,923
1984	1,341	39.4	29.36	43,713
1985	1,232	34.6	28.07	42,374
1986	1,188	19.5	16.42	18,189
1987	1,162	20.7	17.79	16,328
1988	1,209	18.9	15.60	12,550
1989	1,289	21.5	16.72	14,453

Note: A barrel of crude oil equals approximately 6.29 kiloliters.

Source: Ministry of Finance

Japan managed to reduce its oil consumption during the 1970s and 1980s through both energy conservation and the substitution of other sources of

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[1] Department of Energy, Energy Information Administration, International Energy Outlook 1990 (Washington, D.C.: Government Printing Office, 1990), pp. 34-35.

[2] Bank of Japan, Comparative Economic and Financial Statistics 1988, p. 189, and Comparative Economic and Financial Statistics 1990, p. 191.

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energy. Oil met 70.8 percent of Japan's energy requirements in fiscal 1970 (April 1970-March 1971) and 73.3 percent in FY 1975, but this figure fell to 65.8 percent in FY 1980 and to below 60 percent by the mid-1980s. In addition, energy use per unit of GNP also declined. Using a Bank of Japan index, energy consumed per unit of real GNP was 8.5 percent lower in 1980 than in 1978. The figure fell continuously during the early and mid-1980s and was 19.4 percent lower by 1987, the most recent year for which data are available.[3] Table 2 tells the story for more recent years. Oil's share of Japan's energy supplies has remained roughly constant, while overall energy use has risen. GNP, however, has grown even faster, with the result that real GNP produced per unit of energy used has increased. (For details of Japan's energy policies and information concerning the structure of energy demand, see JEI Report No. 40A, October 20, 1989.)

Table 2: Japan's Changing Energy Consumption, FY 1985-FY 1989

Fiscal Year	Energy Consumption*	Percent from Oil**	GNP per Million Kiloliters***
1985	293	56.7%	Y1.00
1986	294	56.8	1.03
1987	308	56.9	1.03
1988	325	57.3	1.03
1989	337	57.9	1.04

*Millions of kiloliters of crude oil equivalent.
**Oil consumption as share of all energy consumption measured in crude oil equivalent.
***GNP in 1980 prices.

Source: Ministry of International Trade and Industry

On the important question of diversification of sources, Japan narrowed its dependence on Middle Eastern crude from a high of 84.6 percent in 1970 to 68.6 percent in 1981, according to the Ministry of International Trade and Industry (see Table 3). In recent years this figure has hovered around 70 percent. (For details on Japan's overall political and economic relationships with the Middle East, see JEI Report No. 9A, March 4, 1988. For recent political and economic developments, see JEI Reports No. 31B, August 10, 1990, and No. 32B, August 17, 1990.)

Japan and the United States Compared

A comparison of crude oil imports underscores Japan's reasonably successful efforts at conservation vis-a-vis the United States. At the time of the second oil crisis in the 1979-80 period oil imports corresponded to a much higher percentage of Japan's economy than they did for the United States. But by 1989 the difference had disappeared almost entirely (see Figure). The plummeting price of oil during the late 1980s as indicated in Table 1 increased the

[3] Ibid., 1988, p. 170, and 1990, p. 176.

Table 3: Japan's Dependence on Middle East for Crude Oil, 1970-89

	Middle East Crude Imports (million barrels)	Share of Crude Imports	Top Crude Supplier	Share of Crude Imports
1970	1,049	84.6%	Iran	43.4%
1975	1,293	78.1	Saudi Arabia	29.8
1980	1,173	73.3	Saudi Arabia	35.3
1981	981	68.6	Saudi Arabia	37.6
1982	937	70.2	Saudi Arabia	39.7
1983	918	70.5	Saudi Arabia	33.3
1984	941	70.2	Saudi Arabia	32.0
1985	861	69.8	Saudi Arabia	23.3
1986	813	68.5	United Arab Emirates	22.1
1987	784	67.5	Saudi Arabia	22.0
1988	817	67.6	United Arab Emirates	20.2
1989	912	70.7	United Arab Emirates	20.4

Note: In this context the Middle East (literally, West Asia) includes Iran, Iraq, Bahrain, People's Republic of Yemen, Saudi Arabia, Kuwait, Qatar, Oman, Yemen, Israel, Jordan, Syria, Lebanon, United Arab Emirates, Gaza and Turkey. This definition does not necessarily correspond to the one used by the Japanese government for other purposes.

Source: Ministry of International Trade and Industry, Tsusho Hakusho (Trade White Paper), various years.

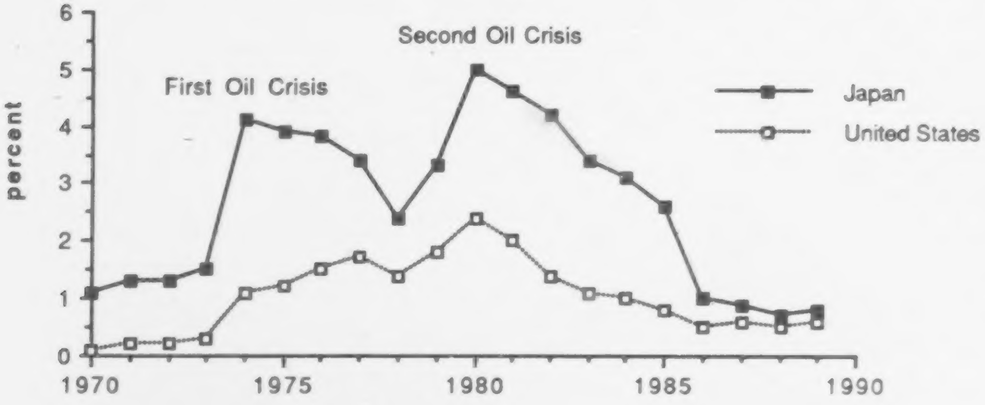
apparent (but not the real) effectiveness of conservation efforts in both countries.

The convergence of Japanese and American ratios regarding the role of imported oil in their economies is extremely important. Oil is an internationally traded, largely interchangeable, commodity. For this reason Japanese and American oil importers pay roughly the same price. A given percentage increase (or decrease) in this price will have virtually the same effect in both countries, other factors being equal. For example, if the price of oil were to double, absent exchange rate changes, the United States and Japan would face an increase in their foreign oil bill that would come to almost the same percentage of their respective GNPs. This result, in turn, suggests that American and Japanese policymakers would have to contend with comparable inflationary pressures and threats of reduced growth in the face of a run-up in international oil prices. Depending on where each country stood with respect to inflationary pressures and the threat of recession before the oil price increase, the perceived dangers could differ. Even though a hypothetical price hike might force both to trim GNP forecasts by 1 percentage point, a nation that had expected 4 percent economic growth may be less worried about the prospect of only a 3 percent rise than one that, instead of a 1 percent increase, would have to live with no growth at all.

Of course, adjustments in the United States would be quite different from those in Japan. This country would experience much larger internal income transfers. For any given oil price increase, U.S. oil producers would gain at

Dependence of Japan and United States on Imported Oil

(crude oil imports as percent of gross national product)



Note: U.S. 1989 figure is an estimate.

Sources: Department of Commerce, Economic Planning Agency and Ministry of Finance

the expense of oil consumers. Similarly, there could be regional transfers of real income from oil-consuming regions (New England) to producing areas (Texas and Alaska). Japan would not face such changes. In this sense Japan would have fewer economic and political dislocations.

In other respects the United States arguably would fare better than Japan. While the two nations import roughly the same amount of oil relative to GNP, the same is hardly true for all energy sources. The United States is a large coal exporter, Japan one of its largest customers. (Japan's coking and steam coal imports in 1989 were 27.2 percent in dollar terms of its crude oil imports, up substantially from 8.4 percent in 1980.) If, as has been true in the past, higher oil prices were to pull up coal prices, then Japan would transfer income to the United States and other coal exporters.

Other aspects of trade also may affect the United States and Japan in different ways. Countries that export oil affect world markets as buyers as well. Even should they decide to buy no goods or services with their windfall, their savings would enter world capital markets. These funds have gone largely to Europe and the United States in the past. According to the Bank of England, the United States attracted $14.5 billion of oil exporters' surpluses in 1989, mostly in the form of purchases of U.S. government securities. The United Kingdom had an inflow of $3.2 billion, mostly involving Eurocurrency bank deposits. Oil exporters withdrew a net $4.3 billion from the rest of the world, including Japan.

During previous run-ups in oil prices the capital flow originating in oil-exporting countries became known as petrodollars, which large international banks often ended up using for loans to developing countries. These loans, in turn, generated import demand, with the potential to benefit exporters in the United States, Japan and other countries. For example, in the 1973-82 period many of these funds went to Latin American countries, which tended to spend them in the United States. (Given the problems these loans have created for the banks that made them, large-scale lending to Latin America is not likely to be repeated, but funds generated by oil exporters' current account surpluses will end up being spent by someone.)

Of course, oil exporters also make large purchases of goods and services abroad. As Table 4 shows, the United States and Europe have done much better selling goods to one critical region, the Middle East, than has Japan, especially when exports to that region are compared to imports.

Table 4: Middle East's Trade with Major Partners, 1980 and 1988

	1980	1988
Middle East Imports		
Exporting Country		
United States	11.2%	11.4%
West Germany	9.4	9.6
United Kingdom	7.3	9.1
Japan	13.1	9.0
Italy	6.0	5.4
France	5.6	4.3
Belgium and Luxembourg	2.0	3.3
Switzerland	2.3	3.1
Netherlands	2.6	2.5
Other Countries	40.5	42.3
Total	100.0	100.0
Middle East Exports		
Importing Country		
Japan	18.9%	17.8%
United States	10.1	12.0
Italy	5.7	4.5
West Germany	4.0	3.9
Singapore	3.2	3.7
Netherlands	5.4	3.6
France	8.9	3.5
United Kingdom	3.8	3.2
Brazil	3.9	3.0
Other Countries	36.1	44.8
Total	100.0	100.0

Source: Ministry of International Trade and Industry, Tsusho Hakusho (Trade White Paper), 1989 and 1990 from International Monetary Fund data.

Taken together, capital flows and trade patterns suggest that substantially higher oil prices could lead to increased demand for dollars to buy American goods and to invest in the United States, raising the value of the dollar against other currencies, particularly the yen. However, short-run policy measures by the United States and other industrial countries in response to higher oil prices could prevent such a development. In this respect the effects of oil price hikes on Japan are simpler: the direct impact of higher oil revenues on demand for Japanese exports is minimal.

The Macroeconomics of Scarce Oil

The export side of the equation suggests that the cloud of much higher oil prices could have a silver lining for the United States, despite its large appetite for imported oil. But the resultant storm could be a severe one for this country, as it would be for Japan. Despite recent declines oil still looms large in Western economies.

If the supply of oil is disrupted, prices either rise or they do not; either outcome is undesirable. If the price for some reason is not allowed to increase and thus reduce the quantity demanded to the now smaller amount supplied, then oil customers would face shortages. In such cases a firm or an individual willing to pay the going price is unable to obtain the product. Americans who waited in gas lines in the 1970s obviously were in this situation. Some businesses that are very productive users of oil may have to go without, even though they would be willing to pay very high prices. The supply capacity of the economy is reduced directly in this situation; a 20 percent drop in oil supplies may imply close to a 20 percent reduction in the output of products using oil since producers have no price incentive to seek other ways of making their product. In this sense an oil supply disruption would be somewhat like a widespread labor walkout.

If oil prices are allowed to rise, the adjustment process works a little more smoothly. Despite the almost universal pain, higher prices create an incentive to fund substitutes for refined oil products. Rather than berating the bureaucrat for doling out what inevitably would seem an unfair allocation, a manufacturer expends its efforts seeking substitute energy sources and/or less energy-intensive production processes; failing that, the company raises prices, which leads the consumer to make further substitution choices. Because substitution prospects are available, the shock to the production of national output is much less then if oil supplies are restricted. In other words, a recession is less likely. While gasoline prices may skyrocket, no one will have to spend time waiting in line.

Price adjustments minimize, but do not eliminate, the loss to potential GNP arising from an oil supply disruption. This reality led economists after the first oil shock to pay much more attention to a previously almost neglected aspect of macroeconomics: aggregate supply. Following a dramatic drop in supplies of a key commodity like oil, the aggregate supply concept suggests that, as in any other market, overall prices and aggregate output (GNP) will adjust. Prices could rise faster and output could decline as compared to a situation without a supply disruption. In other words, inflation and unemployment might both worsen.

Large oil importers like Japan face another potential complication: a deterioration in their terms of trade. Higher oil prices mean that the domestic economy somehow will have to adjust to getting less on world markets for any given level of its exports. If oil prices double, for example, only six barrels of oil rather than 12 would trade for a Japanese-made videocassette recorder. (For a country like the United States with the potential for significant shipments to oil exporters, the terms of trade may not deteriorate.) If the big oil-importing country has limited means of increasing production, it can reduce domestic consumer spending in order to free up some output to pay for the more expensive oil. Alternatively, it may have to substitute domestically made products for some of its nonoil imports, reducing production of still other goods to accomplish this objective. Exactly what choices an economy makes to adjust to these problems is unclear, but it will end up poorer than if higher oil prices simply resulted in an internal redistribution of real incomes. For Japan this effect would be larger to the extent that the prices of other imported energy sources, such as coal, also would rise.

These arguments may be made another way. If the price of a major import like oil were to rise, then imports would tend to be higher in total. (The exception is the unlikely case where the oil price hike led to vigorous efforts to find substitutes, which might result in a smaller oil bill despite the price hike.) Higher imports imply (in Japan's case) a downward movement in the current account surplus. As a result, two reactions in international financial markets are possible. Faced with a suddenly higher demand for foreign currency relative to yen, the Japanese currency could depreciate to make Japanese exports cheaper and imports more expensive, this would lead to lower real consumer spending. Alternatively, if the exchange rate remained where it was, the capital outflow would be smaller, meaning that the acquisition of foreign assets -- and the eventual financial return on those assets -- would diminish. In short, some combination of a weakened currency and a smaller capital outflow would be the way Japan paid its higher foreign oil bill. This argument also suggests that Japan could be poorer as a result of higher oil prices regardless of how the steeper prices are accommodated.

Japan's Experience during the Two Oil Shocks

Adult Japanese, at least, need no instruction on the harm that apparently can come from an oil shock. During the 1973-74 oil shock and the one spanning 1979 and 1980 the Japanese economy suffered considerable dislocation. Some aspects of economic hardship not necessarily linked to oil were associated with the crises anyway. This version of causality may have stemmed from a deeply ingrained fear that Japan, as a small island nation, is particularly vulnerable to disruptions in the supply of imported natural resources.

First Oil Shock - The Middle East war in October 1973 set the stage for steep hikes in oil prices. In mid-October 1973 the Organization of Arab Petroleum Exporting Countries increased the price of a barrel of Arabian light crude from \$3.01 to \$5.12. At the start of 1974 the organization raised the benchmark again, this time to \$11.65. It also announced reductions in oil shipments. Japan was slapped with a 10 percent cutback in October, which was increased to 25 percent in November. A scheduled cut to 30 percent for December was reduced prior to full implementation to 15 percent. Supply restrictions lasted until March 1974. During the same period the United States suffered greater cuts, and European nations' reductions generally were comparable to

Japan's.[4] On average the price Japan paid for oil jumped 31.1 percent in 1973 and another 228 percent in 1974.

In short order the Japanese economy went into a tailspin. As indicated in Table 5, Japan experienced a negative rate of inflation-adjusted GNP growth in 1974, with the first three months of 1974 registering a remarkable 3.1 percent decline from the previous quarter for an annualized rate of contraction of 11.7 percent. In addition, labor market conditions quickly worsened as measured by the ratio of job openings to people seeking employment; while in 1973 openings substantially exceeded applicants, two years later just the reverse was true. Finally, the rate of inflation soared in 1974. The Japanese economy that year combined its worst performance with the highest rate of inflation since the period immediately following World War II.

Table 5: Japanese Economic Indicators During Two Oil Shocks

	Oil (dollars per barrel*)	Real GNP Growth	Wholesale Prices	Job Opening Ratio	Money Supply Growth**
1972	$2.51	8.5%	0.8%	1.16	26.5%
1973	3.29	7.9	15.8	1.76	22.7
1974	10.79	-1.4	31.4	1.20	11.9
1975	11.86	2.7	3.0	0.61	13.1
1978	13.76	5.2	-2.6	0.56	11.7
1979	18.92	5.3	7.3	0.71	11.9
1980	32.97	4.3	17.8	0.75	9.2
1981	37.29	3.7	1.4	0.68	8.9

*Computed from customs-clearance trade statistics.
**M2+CDs.

Sources: Ministry of Finance, Economic Planning Agency, Bank of Japan and Management and Coordination Agency

Japan's external situation deteriorated as well. The yen dropped modestly in value against the dollar, falling from an average market value of Y271.7=$1.00 in 1973 to Y292.1 in 1974 and Y296.8 in 1975. Given the high rate of inflation, this may have amounted to a real appreciation. In any case the current account moved from a $6.6 billion surplus in 1972 to a small deficit in 1973; the following year the deficit swelled to $4.7 billion. The 1972 black-ink entry represented the largest surplus in Japan's postwar history up to that time, the 1974 figure the largest deficit.

[4] For details of this period, see Yuan-li Wu, *Japan's Search For Oil* (Stanford, California: Hoover Institution Press, 1977), especially pp. 3-8 and pp. 28-36; and Edward J. Lincoln, *Japan: Facing Economic Maturity* (Washington, D.C.: Brookings Institution, 1988), pp. 26-38.

At first blush the oil supply disruptions and the run-up in oil prices in the 1973-74 period would appear to be culpable for the economy's bad performance. However, many Japanese analysts accord substantial blame to an excessively easy monetary policy (indicated at least approximately in Table 5 by the growth in the money supply measure M2+CDs) and soaring government spending.[5] They argue that the money supply was growing rapidly even before the oil price shock and that inflation rates also were picking up. Whatever the merits of this argument, most Japanese and foreign experts regard the period as an important psychological turning point in Japanese economic history; 1973 often is regarded as the end of the postwar high growth era. Within a few years Japan, of course, did get over the oil shock. During the mid-1970s oil prices were relatively stable. Growth rates in Japan, however, did not return to the pace of the preshock days.

Second Oil Shock - In late 1978 the world oil market's attention again turned to the Middle East. The political upheaval in Iran in the autumn of that year noticeably tightened oil markets. In March 1979 the Organization of Petroleum Exporting Countries made matters worse from the standpoint of oil consumers by sanctioning the practice of additional levies on oil. In short, OPEC set its members free to raise prices. The resulting increase continued into 1980, with prices getting an extra boost from supply disruptions caused by the Iran-Iraq war, which began that year. The Department of Energy's index of real crude oil prices rose 271 percent between 1978 and its peak in 1981.

By most accounts the Japanese economy escaped with less damage this time around (see Table 5). Real GNP did not experience a single quarter of shrinkage between 1978 and 1981; in fact, growth exceeded 5 percent in both 1978 and 1979. Moreover, the job openings-applicant ratio, which had not really recovered after the first oil shock, did not lose any additional ground. Wholesale prices, which had declined 2.6 percent in 1978, jumped 7.3 percent in 1979 and another 17.8 percent in 1980 before falling back to a 1.4 percent rise in 1981. Retail prices, which had shown almost as big a jump as wholesale prices during the first oil crisis, rose much more moderately after the second shock. The peak, a 7.7 percent increase in 1980, was close to the 7.3 percent average annual rise between 1975 and 1978.

Japan's foreign trade was affected, of course. As oil prices rose the yen sank from an average of Y210.4 to the dollar in 1978 to a nadir of Y226.7=$1.00 in 1980. A measure of the real exchange rate calculated by the International Monetary Fund showed a 21.7 percent drop in the yen's value over the same two years. This depreciation, however, was not enough to prevent a sharp deterioration in the current account from a surplus of $16.5 billion in 1978 to deficits of $8.8 billion and $10.8 billion in 1979 and 1980, respectively. The 1980 figure, the largest current account deficit in dollar terms that Japan has ever recorded, came to 1.1 percent of GNP.

Several Japanese economists have pointed with some pride to Japan's apparently successful efforts to weather the second oil shock.[6] Japan's experience in the 1979-80 period stands in apparent contrast not only to the trials it endured during the first oil crisis but to what the United States faced during the second one. Lengthy gas lines, soaring inflation and stagnant economic growth almost certainly were factors that led voters to reject President Carter's reelection bid in 1980.

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[5] For a summary of this argument, references and a critical assessment, see Lincoln, op. cit., pp. 34-35.

[6] See, for example, Yoshio Suzuki, "Why Has the Performance of the Japanese Economy Been So Much Better?," Journal of Japanese Studies (Summer 1981), pp. 403-413.

Other analysts paint a more complicated picture of Japan's experience during this period. For example, the staff of the Organization for Economic Cooperation and Development found roughly equivalent adverse effects from oil prices on the Japanese economy in the two shocks. They calculated that the cumulative effect of higher oil prices over the 1973-74 and the 1979-80 periods trimmed real GNP by about 3 percent from levels that it otherwise would have reached. Furthermore, because the prices of internationally traded nonoil goods also moved against Japan more during the second shock, the overall adverse impact on the Japanese economy probably was greater during the 1979-1980 period. The OECD economists concluded in a 1980 report that the effect seemed smaller in part because it was spread out more evenly over the two years. Moreover, they found that the second shock resulted in less short-term dislocation because savings behavior, monetary and fiscal policies, inventory adjustment and investment behavior were more orderly.[7]

Impact of Higher Oil Prices on Japan in the 1990s

Japan's economy is, of course, much different today than even in 1980. As noted earlier, oil imports as a percentage of GNP are smaller now than before the 1979-80 run-up in prices. This suggests that the terms-of-trade effects from an oil price hike could be much less. In fact, with the United States and Japan now nearly equally dependent on imported oil by this measure, the effects should be about the same in the two countries. However, the jump in oil prices in July and August 1990, especially following Iraq's invasion of Kuwait and the subsequent embargo on Iraqi and Kuwaiti oil, has sent economists all over the world scurrying back to their computers to dust off simulations of the impact of a dramatic rise in energy prices.

Japanese analysts so far have assumed that oil prices will rise much less dramatically than they did in either of the oil crises of the 1970s. For example, the Economic Planning Agency estimated that if oil prices were to go up 10 percent, domestic Japanese prices would rise 0.3 point faster than otherwise. As another possible scenario, EPA considered the effect of $25-a-barrel oil, a figure reportedly advocated by Iraq at OPEC meetings in July. The result would be a 1 point rise in Japanese wholesale prices. Yen for yen, a given hike in oil prices now would deliver, in EPA's calculation, half the inflationary boost of the 1979-80 increases.

Estimating the impact on the current account, the Ministry of Finance figured that, if oil were to remain about $25 a barrel, Japan's surplus would decline by $10 billion or a little less than 20 percent from its 1989 level. MOF cautioned, however, that this improvement would bring little relief from trade frictions since the decline would not reflect any change in bilateral imbalances with the United States or Europe.

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[7] Organization for Economic Cooperation and Development, Japan (Paris: 1980), pp. 50-64.

These calculations risk being overtaken by events. In early August the price of crude on international markets temporarily approached $30 a barrel. Nihon Keizai Shimbun published the results of a simulation using its own econometric model that considered the impact of the price of oil at a sustained level of $30 a barrel rather than $17 a barrel. In the October 1990-March 1991 period the effect would be to shave 0.2 percentage point off the real annualized GNP growth rate. The early August Nikkei report did not include estimated results for FY 1991, when the impact probably would be felt most keenly.

Even at $30 a barrel, however, oil is comparatively cheap compared to previous years. In real terms this price still would be lower than that of any year between 1980 and 1985, for example. In fact, between 1985 and 1988 the world enjoyed a sort of reverse oil shock as the price of crude dropped by more than 50 percent in dollar terms and even more in terms of the yen, which appreciated against the American currency (see Table 1). That most of these years were prosperous ones for Japan should come as no surprise in light of its apparently adverse experience from the oil price rises of the 1973-74 and the 1979-80 periods.

A 1988 OECD study of how the collapse in oil prices affected Japan between 1986 and 1988 found that the fall from a baseline level of $26.50 a barrel to $14 in 1986, $17 in 1987 and $18 in 1988 had a cumulative effect of making Japanese GNP 2.7 percent larger than it would be otherwise.[8] During the three years through June 1990 Japanese oil prices averaged $16.85, close to the $16.33 figure OECD used as the average for the 1966-88 period. Hence, running the numbers in reverse is not totally unreasonable. In other words, the low oil prices between 1987 and 1990 could be used as the baseline relative to a level of $26.50-a-barrel oil. This exercise suggests a substantial negative impact on the Japanese economy over a period of years.

Other Considerations

Structural changes in the Japanese economy no doubt would result in quite different responses to a rapid run-up in oil prices today, particularly if the higher levels were maintained, than happened during the two earlier oil shocks. Some would cushion the blow, but others could aggravate it. On the favorable side Japan's economy probably responds more to price signals than it did a decade ago. Many more interest rates are deregulated, for example. Within the petroleum industry some -- but not all -- nonprice means of allocating production and distribution among firms have been eliminated. This means that substitution possibilities are much greater than otherwise, reducing the potential shock to output.

Other differences have less clear-cut benefits. Press reports in Japan and the United States have emphasized the role of special petroleum reserves in both countries. In Japan's case both the private and the public sector control reserves, with the government probably having decisive influence over the use of the private reserves. As of early August private reserves totaled 322 million barrels, an estimated 88-day supply; public stores of 197 million barrels or 54 days yielded a total reserve of 519 million barrels -- a 142-day supply.

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[8] Organization for Economic Cooperation and Development, Japan 1987/1988 (Paris: 1988), p. 53.

(The reserves were established on the basis of a 1975 law; actual development began in 1978, just before the second oil crisis. The reserves, however, were not tapped at that time.)

Since oil prices are set on global markets oil reserves would affect prices only insofar as they affect global supply -- unless countries holding reserves adopt policies to sever the linkage between domestic and international prices. Even then, the terms-of-trade effect, which depends on the price nations pay on international markets, would not be significantly offset. In most cases only a widespread -- and probably internationally coordinated -- release of reserves by Japan, the United States and others would have a significant effect on Japan's and this country's ability to cope with a large supply disruption. Hence, the relevant figure is international oil reserves. The International Energy Agency, an organization of wealthy oil-consuming nations, has estimated that July 1990 worldwide reserves were 3.4 billon barrels, or a supply of about 98 days. Japan's reserves would appear to equal about 15 percent of the total.

The structure of financial markets is another complicating factor. They are much larger and more complex than they were even in 1979 and 1980. For example, according to many analysts, outbound capital flows became substantially easier as a result of the 1980 revision of Japan's Foreign Exchange and Foreign Trade Control Law. In a sense the larger movement of capital overseas is a safety valve for the Japanese economy; reductions in the outbound capital flow would be one way to handle a larger import bill. However, should a future oil crisis create, as it has in the past, an image of the United States as a safe haven, outbound capital flows from Japan could surge. To accommodate the larger capital flow, the current account surplus would have to end up larger -- not smaller as implied by the larger oil bill. This implies a larger adjustment problem than would exist in the absence of relatively free capital flows. Concretely, it could mean a surge in Japanese exports.

The now huge Japanese stock market represents a further complication. Some analysts contend that a "wealth effect" was a major factor in sustaining Japan's boom between 1986 and 1989. Should higher oil prices or another international crisis pull down stock prices significantly for a prolonged period, some investors would feel less wealthy and therefore reduce their spending. If a reverse wealth effect materialized, it could complicate the already difficult macroeconomic policy choices needed in such an environment.

If oil prices were to rise substantially over the next year or so, Tokyo and Washington would face a tricky task of policy coordination. The Federal Reserve Board might be tempted to loosen the money supply to avoid the recession that was widely expected even before the prospect of more expensive oil. Since the Japanese economy appears far stronger at the moment the Bank of Japan probably would see its job as tightening monetary policy significantly to reduce the inflationary pressures arising from such a hypothetical oil price increase. If the Fed and BOJ were to take this combination of actions, interest rate differentials, which have been uncharacteristically microscopic in recent months, might disappear completely. This development would have unpredictable consequences for the dollar, which has been sustained in part by higher interest rates in the United States.

Conclusion

Oil shocks -- as much as the reasons causing them -- present policymakers with a dilemma. If they ease monetary and fiscal policies, they risk aggravating already serious inflationary trends. If they tighten the supply of money and cut government spending or raise taxes, they may be blamed for increasing unemployment or reducing the rate of economic growth. In both oil crises of the 1970s, Japanese policymakers tended to risk slower or even negative economic growth by pursuing the second option. As of August 1990 the Bank of Japan widely was believed to be leaning toward a tighter monetary policy even in the absence of a run-up in oil prices; more expensive oil would strengthen that resolve.

Japanese policy depends in part on what happens in the United States. Not only is the American market still an important one for Japanese exporters, but capital markets in the two countries are linked closely. Hence, a recession in the United States, whether or not it was oil-related, could reduce the demand for Japanese goods and have a measurable negative impact on Japan's economy. However, an expansionary U.S. fiscal policy stance -- which is not improbable considering the U.S. military buildup in the Middle East, the possibility of conflict and inattention to cutting the federal budget deficit -- could boost demand for Japanese goods in this country.

Given its dependence on foreign oil and other imported energy resources, a future run-up in world petroleum prices would have an adverse effect on Japan. Such increases could present Japan with some difficult policy choices to limit that damage. Of course, Washington would hope that Tokyo does not try to minimize the dislocation at America's expense. Japan's relative self-confidence in the past few years makes it more willing to take actions that result in some short-term pain for itself; it realizes that higher oil prices need not be devastating for the economy. For example, Japan may be willing to live with the higher oil prices that follow in the wake of an embargo against Iraqi and Kuwaiti oil because it realizes that in the long run preventing Iraq from getting control of OPEC would help keep oil prices low.

As a more important player in the international economy than in 1973 or even 1980, Japan may be aware that it receives a proportionately larger part of the benefits from any positive role it takes in international economic actions to enhance the common good of oil-consuming nations. Hence, Tokyo may be more willing to take such actions. This larger role also implies that its policies receive more international scrutiny -- with the risk of severe criticism -- than during the first and the second oil crises. In August 1990, as the threat of a third oil shock seems more real than at any time in recent memory, Japan's economic self-confidence is apparent. The political leadership in Washington and in other world capitals is hopeful that this confidence will find reflection in Tokyo's international economic policies.

For further information, contact Douglas Ostrom.

Margit McGrath provided research assistance.

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The views expressed in this report are those of the author and do not necessarily represent those of the Japan Economic Institute.

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JEI

REPORT

A Two-Part Report: A and B

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IN THIS ISSUE:

Japan's Current Surplus Registers Another Sharp Drop 1

Mixed Japanese Response To Energy Conservation .. 3

Japan, Soviet Union Continue To Seek Warmer Relations 5

Television: The Fight Goes On 6

Japan's Current Account Surplus Registers Another Sharp Drop

If sometimes the best surprise is no surprise, foreign observers have reason to be pleased with Japan's latest current account statistics. Despite turbulent financial markets in Japan and the prolonged weakness of the yen, the surplus dropped a whopping 42.3 percent during 1990's second quarter from the April-June 1989 period (see Table 1). This now familiar pattern represented the sixth quarter in a row that Japan's current account had declined. Most of the drop resulted from the shrinking trade surplus, which was down 30.8 percent. With some adjustments these trade figures reflected the customs-clearance statistics released earlier (JEI Report No. 29B, July 27, 1990), which showed an 18 percent erosion in the surplus.

The April-June 1990 deficit in services trade, which consists mostly of net travel and transportation receipts plus net investment income, reached an all-time quarterly high. The funds spent by Japanese tourists abroad widen the deficit; income received on investments in the United States and elsewhere narrow it. As such, the latest data demonstrated the apparent staying power in the overseas travel boom even in light of the weak yen over the past year. The numbers also pointed to the relatively small impact to date of income from offshore investments despite Japan's status as the world's largest net holder of overseas assets.

Table 1: Japan's Balance of Payments

(in millions of dollars)

		Trade Balance	Exports (f.o.b.)	Imports (f.o.b.)	Services (net)	Current Account Balance	Long-Term Capital (net)
1985		$55,986	$174,015	$118,029	$-5,165	$49,169	$-64,542
1986		92,827	205,591	112,764	-4,932	85,845	-131,461
1987		96,386	224,605	128,219	-5,702	87,015	-136,532
1988		95,012	259,765	164,753	-11,263	79,631	-130,930
1989		76,917	269,570	192,653	-15,526	57,157	-89,246
1988:	I	21,021	59,345	38,324	-1,337	18,421	-15,142
	II	22,448	63,559	41,111	-2,882	18,567	-36,556
	III	23,765	65,989	42,224	-3,623	19,052	-42,214
	IV	27,778	70,872	43,094	-3,421	23,591	-37,018
1989:	I	21,311	66,945	45,634	-3,595	16,064	-5,612
	II	19,794	66,560	46,766	-4,892	14,283	-30,801
	III	19,770	68,157	48,387	-4,023	14,957	-21,559
	IV	16,042	67,908	51,866	-3,016	11,853	-31,274
1990:	I	14,393	65,460	51,067	-701	12,305	-16,086
	II (p)	13,693	65,384	51,691	-5,022	8,245	18,721

As Japan's current account has declined, its mirror image -- net capital flows -- predictably has shrunk as well. Net purchases of foreign stocks as well as bonds in the April-June period declined compared to a year earlier (see Table 2). However, investment by Japanese companies in overseas facilities increased 10.1 percent to $12.8 billion, the third-highest quarterly figure ever and the first time since 1980 (when all overseas capital flows were a fraction of their current size) that direct investment exceeded portfolio investment. Unlike investments in stocks, bonds and bank instruments, direct investment typically cannot be repatriated with a couple of strokes on a keyboard. For this reason direct investment probably creates fewer jitters on financial markets, although it usually has a higher public profile -- particularly when foreign-owned factories appear to sprout from corn fields. Should the recent trend in these capital flows persist, the structure of Japan's foreign investment would come to resemble that of the United States. Direct investment abroad by Americans is far more significant than their holdings of stocks and bonds issued overseas.

With Japan's current account registering a 32.3 percent drop in the first half of 1990, it would appear to be on track for another substantial year-to-year decline. Just prior to Iraq's invasion of Kuwait, Nomura Research Institute forecast that Japan's 1990 current account would total $50.7 billion, an 11.3 percent drop from 1989's level. However, events in the Middle East could play havoc with future trade figures. During the April-June quarter Japan's crude oil imports averaged $17.09 per barrel. Should imported crude average $25 a barrel for the remainder of 1990 (slightly below mid-August prices), roughly $2.5 billion would be trimmed from Japan's current account surplus each

Table 2: Japan's Net Purchases of Foreign Securities

(in millions of dollars)

	Bonds			Stocks		
	Purchases	Sales	Net	Purchases	Sales	Net
1985	$291,338	$237,859	$53,479	$5,484	$4,489	$995
1986	1,346,989	1,253,965	93,024	20,917	13,869	7,048
1987	1,273,829	1,200,944	72,885	70,936	54,062	16,874
1988	1,364,061	1,278,249	85,812	76,560	73,567	2,993
1989	1,683,733	1,589,650	94,083	97,056	79,169	17,887
1988: I	332,047	318,877	13,170	18,901	19,467	-566
II	401,293	374,371	26,922	20,518	20,643	-125
III	333,473	307,635	25,838	25,166	23,425	1,741
IV	297,248	277,366	19,882	11,975	10,032	1,943
1989: I	341,774	327,771	14,003	17,724	17,828	-104
II	487,087	461,996	25,091	21,228	15,120	6,108
III	463,493	437,622	25,871	23,602	18,807	4,795
IV	391,379	362,261	29,118	34,502	27,414	7,088
1990: I	356,393	355,524	869	27,640	22,694	4,946
II (p)	350,993	341,640	9,353	19,972	17,819	2,153

quarter, although conservation efforts could affect this amount. This argument suggests that, depending on the world oil market, this year's surplus easily could dip below Nomura's estimate.

Douglas Ostrom

Mixed Japanese Response To Energy Conservation

Despite concern over the impact of the Middle East situation on oil supplies, energy conservation has not become a consuming passion in Japan. This response contrasts starkly with the panic that gripped the nation in the 1973-74 period and again in the 1979-80 period when oil prices skyrocketed. Although the government and businesses have reinstituted public education programs and are encouraging voluntary conservation steps, these actions appear to be barely impinging on the public's pursuit of a higher standard of living. In the long run, however, the crisis generated by Iraq's invasion of Kuwait will hasten efforts to improve the nation's energy efficiency and to develop alternative energy sources.

The Kaifu administration has responded to the self-imposed embargo of Iraqi and Kuwaiti oil with restraint to avoid creating a crisis atmosphere. Government officials have made it clear that they view the Tokyo stock market's sharp drop in the wake of Iraq's invasion as an overreaction. Since 1978 the government has stockpiled 31.4 million kiloliters of crude oil, enough to supply the country's total needs for 54 days. The private sector has 51.3 million kiloliters in storage, adding another 88 days' supply. Since the embargo on

R5650-2

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REPORT

A Two-Part Report: A and B

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IN THIS ISSUE:

Japan Grapples With Middle East Response 1

Japan's Middle East Aid Expected To Reflect Crisis 4

Japanese Public Waits For Government Action On Middle East 6

Japan's Stock Market: Is The Party Over? 7

President Signs Log Export Ban 9

Japan Grapples With Middle East Response

History may show that Iraq's August 2 invasion of Kuwait and its subsequent condemnation by most of the international community marked a watershed in Japan's global diplomacy. Tokyo responded relatively quickly August 5 in joining its Western partners in a trade embargo of Iraq and Kuwait as well as in a suspension of all financial transactions with the two countries and foreign aid to Baghdad. Yet it soon became clear that the United States and other Western allies expected Japan to shoulder more of the burden of defending its oil lifeline and protesting Iraq's contravention of the rules of international diplomacy. At JEI press time Tokyo was expected to announce an "outline" of assistance to Arab countries potentially harmed by Iraqi actions. The package also was expected to indicate measures Japan would take to support the Western military effort.

In drawing up this plan Tokyo was forced to consider how its prominence in the post-Cold War order may necessitate a reinterpretation of the legal constraints on the dispatch of military power overseas. Japan also was confronted with the suggestion that its oil-oriented Middle East policy, which up until this point has emphasized nonconfrontation and goodwill to ensure that the

Japan's Middle East Aid Expected To Reflect Crisis

Urged by Western and Arab leaders to do more than support economic sanctions on Iraq and Kuwait, Tokyo has been taking a hard look at how Japan can contribute to resolve the Persian Gulf crisis in view of constitutional constraints prohibiting military involvement (see preceding article). Foreign aid is the most frequently mentioned option. In 1988, the last year for which complete data are available, Japan disbursed approximately $583 million in official development assistance to the Middle East (see Table). How Tokyo will allot new forms of aid remains under discussion. Foreign Ministry officials have said they will assess the damage that sanctions have inflicted on other Middle East economies and determine relief funding on a case-by-case basis. Feedback from Foreign Minister Taro Nakayama's August 17-24 discussions with leaders in Saudi Arabia, Oman, Jordan, Egypt and Turkey is expected to play a key role in formulating a new aid package for the region.

Key Recipients of Japan's Official Development Assistance in the Middle East,* 1984-88

(in millions of dollars)

Country	1984	1985	1986	1987	1988
Egypt	$81.5	$73.0	$125.7	$93.9	$172.9
Iraq	-4.6	14.7	15.2	70.2	-10.1
Jordan	19.8	13.2	37.5	24.4	14.5
Kuwait	0.3	0.4	0.4	0.5	2.8
Morocco	38.4	22.2	13.3	20.5	28.1
Saudi Arabia	21.7	10.9	13.5	2.9	6.5
Sudan	28.8	25.8	32.7	77.7	59.6
Syria	1.6	-1.0	7.7	45.1	107.1
Tunisia	19.4	10.5	5.2	0.9	36.7
Turkey	36.9	26.0	71.2	162.4	134.5
Yemen	9.9	10.5	15.8	21.1	25.9
Total Middle East ODA	249.0	201.0	340.0	526.0	583.0

Note: According to the Foreign Ministry's regional classification, the Middle East includes Afghanistan, Algeria, Bahrain, Egypt, Iran, Iraq, Israel, Jordan, Kuwait, Lebanon, Libya, Morocco, Oman, Qatar, Saudi Arabia, South Yemen, Sudan, Syria, Tunisia, Turkey, United Arab Emirates and Yemen. This definition does not necessarily correspond to the one used by the Japanese government for other purposes.

Source: Ministry of Foreign Affairs

Japan's continued dependence on Middle Eastern crude oil for about 70 percent of its imported petroleum supplies gives it an obvious interest in maintaining stability in the region. In recent years Tokyo has chosen to contribute to this objective through foreign aid. This helps explain why a country such as Saudi Arabia, which has a higher per capita income than most of Japan's foreign aid recipients, still receives economic assistance.

Most of Tokyo's foreign assistance in the Middle East, however, has been earmarked for nonoil-producing, moderate countries such as Turkey and Egypt. Egypt has appeared frequently among the 10 top official development assistance recipients in recent years. Foreign Minister Nakayama's recent talks with Egyptian President Hosni Mubarak indicated Cairo needed about $2 billion to help offset the economic losses incurred after Iraq's invasion of Kuwait. President Mubarak reportedly also asked Japan to craft an economic reform package in conjunction with the United States and the International Monetary Fund to help his country address its severe debt problems. A Japanese aid package reportedly was promised to Cairo, but the amount was not disclosed.

Mr. Nakayama heard similar requests for assistance at each stop during his recent Middle East tour. Saudi Arabia's King Fahd asked Japan to do everything possible within its constitutional limitations to help end the crisis. Riyadh specifically requested Japanese cooperation with transportation activities in the Persian Gulf, according to Japanese news reports. Mr. Nakayama's meeting with his counterpart in Oman resulted in an agreement that the Gulf nation would send a senior Foreign Ministry official to Tokyo sometime this fall to discuss the details of Japan's possible assistance to that country.

The wide range of requests presented to Foreign Minister Nakayama by Turkish President Turget Ozal included: loans for development projects, assistance in bringing private capital and technology to Turkey, promotion of tourism and expansion of air routes. Mr. Nakayama promised the Turkish leader that he would study these requests, but no specific aid commitments to Turkey or the other Middle Eastern nations were disclosed during his visit. Mr. Nakayama emphasized to the Middle Eastern leaders that while Japan will do its utmost to cooperate with its allies in the region, it cannot provide military assistance.

While Mr. Nakayama was in the Gulf region Foreign Ministry officials announced that Kuwait's exiled emir would dispatch a special envoy to Tokyo to meet with Prime Minister Toshiki Kaifu. The officials indicated that Japan is considering providing assistance for Kuwaiti refugees in Saudi Arabia.

Tokyo has had to balance its desire to assist the Middle East with the recognition that many of the nations in the region have incomes that are relatively higher than those of other aid recipients or levels of debt that preempt additional loans. In recent months this juggling act has produced two loans administered through the Overseas Economic Cooperation Fund -- Japan's soft loan window -- and cofinanced by the World Bank: $246 million for an agricultural project for Turkey and $73 million each from the World Bank and OECF for educational development in Jordan. The share of total Japanese ODA loans directed to the Middle East dropped from 5.5 percent in 1987 to 4.9 percent in 1988, although the actual amount provided increased by Y15.6 billion ($104 million at Y150=$1.00). Japan also has supplemented its aid program in the Middle East by responding to special requests for assistance, such as disaster relief.

Prime Minister Kaifu reportedly has urged relevant cabinet ministers to draw up creative options for Japan to pursue in the Middle East. Although the amount of additional assistance for the region still is being worked out, some foreign aid experts speculate that it will be financed through a combination of regular ODA outlays, specially appropriated funds and private money, such as from the Japan Red Cross. Observers in both the Middle East and the West will be watching to see the extent to which recent events will tilt Japan's foreign aid priorities toward the Persian Gulf.

Margo Grimm

Japanese Public Waits For Government Action On Middle East

Although Japan has joined the world community in imposing sanctions on dealings with Iraq and Kuwait, most Japanese appear to agree that participating only in the international trade embargo is not sufficient. More concrete, visible measures, which seem to be getting little feedback from public opinion polls, are under consideration by the government. While newspapers devote a large volume of space every day to report on developments in the Persian Gulf crisis as well as the situation of Japanese nationals in Iraq and Kuwait, there are few articles covering public attitudes toward the crisis and/or proposed government actions. Moreover, none of Japan's major dailies or television news organizations has done an opinion poll.

Previous responses toward natural disasters and international military crises might help analyze Japanese attitudes to the current Persian Gulf situation. When Mexico was struck by a brutal earthquake in 1984, many Japanese criticized the government for its tardy response in committing rescue help, especially because other countries had responded quickly. Public opinion at that time was instrumental in the drafting and passage of a 1987 law that allows the government to dispatch rescue personnel to overseas disaster areas. As Japan itself is prone to earthquakes and similar natural disasters, most Japanese support Tokyo's help when emergencies of this type strike other countries.

In the face of international military crises, however, Japan in the past has hesitated to take prompt action on its own initiative. An experience in the late stages of the Iran-Iraq war underscores the apprehension with which most Japanese view active involvement. As the war escalated in 1987 then Prime Minister Yasuhiro Nakasone asked for a study preparatory to sending minesweepers to the Persian Gulf, where oil and other shipments of nonwarring parties were threatened in the waterway by submerged mines. However, Masaharu Gotoda, chief cabinet secretary as well as acting foreign minister, reportedly opposed the plan because Japan's constitution restricts it from committing troops at home or abroad except for self-defense purposes. Public opinion at the time mainly supported Mr. Gotoda, not only because of concerns about possible military involvement but also because of worries that Mr. Nakasone might be proceeding too hastily in committing Japan to help keep the Gulf open to shipping.

Prime Minister Toshiki Kaifu has approached the present crisis very carefully. He postponed a long-planned August visit to the Middle East because top government and Liberal Democratic Party officials did not feel Tokyo was in a position to make concrete commitments while the situation in the Persian Gulf still was evolving. These advisers also recognized the difficulty of crafting a response that both would satisfy international expectations of Japan's role and be acceptable to the Japanese public. In putting off his trip Mr. Kaifu also took into account a visit's possible impact on the 500 or so Japanese nationals trapped in Iraq and Kuwait.

The postponement of the visit allowed the prime minister to devote a major share of his time in the second half of August to considering what Japan

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REPORT

A Two-Part Report: A and B

NO. 35A September 14, 1990

JAPAN'S DEFENSE PLANNING IN AN ERA OF GLOBAL CHANGE

Summary

Global developments of the past year have created new challenges for Japanese defense planners as they evaluate future security needs. For decades the threat posed by Soviet military power in the Far East shaped Tokyo's defense planning. Recent changes in the Eastern bloc and improvements in U.S.-Soviet relations have prompted some Japanese policymakers to urge the government to adjust the level of defense spending to reflect these changed geopolitical circumstances. This thinking apparently influenced the cabinet's decision to cap the increase in the Japan Defense Agency's budget for FY 1991 at the lowest year-to-year level in 30 years. The relaxation of East-West tensions also has affected decisionmaking concerning the duration and the procurement needs of Japan's next medium-term defense plan.

At the same time, Iraq's early August invasion of Kuwait has raised serious questions about Japan's responsibilities as a global economic power -- questions that may force Tokyo to reinterpret its constitutionally mandated self-defense mission. Developments in the Persian Gulf at this stage do not appear to have altered Japan's military spending and procurement plans for the coming fiscal year. It is possible, however, that growing international pressures on Japan to shoulder more of the burden of defending its oil lifeline could affect defense planning in upcoming years as well as the nature of Japanese military operations.

Japan Economic Institute 1000 Connecticut Avenue, N.W., Washington, D.C. 20036 202-296-5633

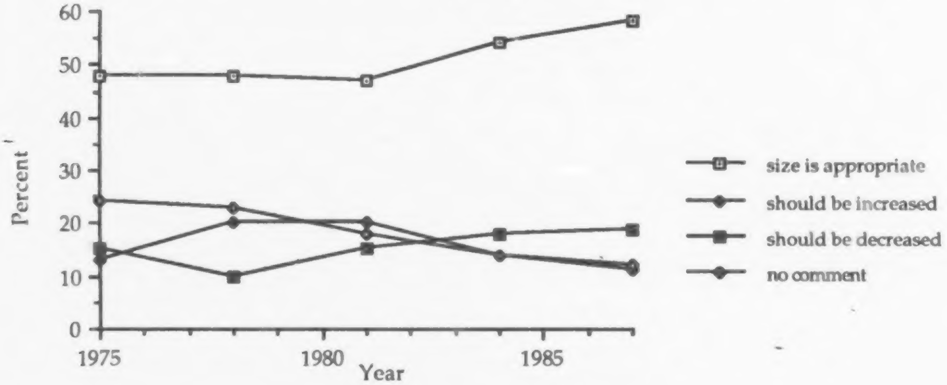
Overview of Japanese Defense Planning

By next spring Japan will have completed its FY 1986-FY 1990 Mid-Term Defense Program, the third five-year plan undertaken in accordance with the National Defense Program Outline. The outline, adopted in October 1976 by the cabinet of then Prime Minister Takeo Miki, serves as an overarching plan or "vision" that stipulates the level of defense capabilities that should be maintained by Japan in peacetime and provides guidelines for the improvement of the country's military capabilities. Its underlying premise is that the military balance between the United States and the Soviet Union and the U.S.-Japan Mutual Security Treaty will play major roles in maintaining international stability and preventing a full-scale attack against Japan. Noting that Japan's "peace" constitution bans the threat or the use of force as a means of settling international disputes, the outline clarifies that Japan nevertheless should possess adequate defense capabilities to enable the country to deal with any aggression directed against the home islands.[1]

Given Japan's World War II notoriety, there exists tremendous sensitivity -- both nationally and regionally -- to a greatly expanded Japanese military role, even when the mission remains defensive in nature. The Japanese people in general appear to take quite seriously their war-renouncing constitution insofar as increased defense outlays are concerned (see Figure 1). Certain of the opposition parties, in fact, advocate a neutral defense posture, arguing that even the existence of a military alliance with the United States stretches the constitution's bounds.

Figure 1: Japanese Attitudes Toward the Defense Budget, 1975-1987

(in percent)



Source: Japan Defense Agency, Defense of Japan, 1989

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[1] Japan Defense Agency, Defense of Japan, 1989, p. 87.

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Due in part to congressional pressures for U.S. allies to share more of the defense burden, Washington over the years has encouraged Tokyo to increase defense-related spending to allow for ongoing qualitative improvements in weapons systems as well as additional procurements to meet expanded military roles and missions in and around the Japanese islands. Domestic and regional sensitivities as well as budgetary pressures still act to constrain Japanese defense spending to only about 1 percent of gross national product (as compared to the 3 to 7 percent spent by the United States and European allies). However, Tokyo has responded to U.S. requests over the past 35 years by steadily expanding military expenditures (see Table 1). The FY 1986-FY 1990 buildup program, in particular, features qualitative improvements in weapons systems and armed forces training.

Table 1: Japan's Defense Budget, FY 1955-FY 1990

(in billions of yen)

Fiscal Year	Initial Budget	Percent Change	Ratio to GNP
1955	Y134.9	-3.3%	1.78
1965	301.4	9.6	1.07
1975	1,327.3	21.4	0.84
1980	2,230.2	6.5	0.90
1981	2,400.0	7.6	0.91
1982	2,586.1	7.8	0.93
1983	2,754.2	6.5	0.98
1984	2,934.7	6.6	0.99
1985	3,137.2	6.9	0.99
1986	3,343.6	6.6	0.99
1987	3,517.4	5.2	1.00
1988	3,700.3	5.2	1.013
1989	3,919.8	5.9	1.006
1990	4,159.0	6.1	0.99

Source: Japan Defense Agency

By the end of the current five-year plan Tokyo will have accomplished most of the personnel and equipment procurement objectives contained in the 1976 National Defense Program Outline (see Table 2). Among the emphasized goals are improved and expanded capabilities in air defense, antisubmarine warfare, ground force response to a manned invasion as well as improved command, communications, intelligence and reconnaissance capabilities. Both the Japan Defense Agency and the Pentagon believe that achievement of these objectives will enable Tokyo to adequately defend its sealanes 1,000 nautical miles east and south, a goal established in a 1981 joint communique signed by former President Reagan and then Prime Minister Zenko Suzuki.

Weapons Procurement and Personnel - When the FY 1990 budget went into effect this past April the Japan Defense Agency was in command of an unprecedented Y4.2 trillion ($27.7 billion at Y150=$1.00) -- reflecting a 6.1 percent increase over the initial FY 1989 figure, the sharpest increase in defense-related funding in four years. The Ministry of Finance initially had proposed a slightly smaller defense budget, arguing that recent developments in East-West relations had created a less hostile security environment. JDA policymakers successfully contended that Japan's defense buildup must continue as planned since the military situation in Asia basically had not changed. Like Pentagon

Table 2: Progress of Defense Buildup under 1976 National Defense Program Outline

Classification	Outline Goal	End of FY 1989	Program Completion
SDF Personnel	180,000	180,000	180,000
GSDF			
Units Deployed Regionally			
Division	12	12	12
Composite Brigades	2	2	2
Mobile Operations Units			
Armored Division	1	1	1
Artillery Brigade	1	1	1
Airborne Brigade	1	1	1
Training Brigade	1	1	1
Helicopter Brigade	1	1	1
Low-Altitude Surface-to-Air Missile Units (anti-aircraft artillery groups)	8	8	8
MSDF			
Antisubmarine Surface Ship Units for Mobile Operations (escort flotillas)	4	4	4
Antisubmarine Surface Ship Units for Regional District Units (divisions)	10	10	10
Submarine Units (divisions)	6	6	6
Minesweeping Units (flotillas)	2	2	2
Land-Based Antisubmarine Aircraft Units (squadrons)	16	14	16
Major Equipment			
Antisubmarine Surface Ships	60	61	62
Submarines	16	15	16
Combat Aircraft	220	194	214
ASDF			
Aircraft Control and Warning Units	28	28	28
Interceptor Units (flight squadrons)	10	10	10
Support Fighter Units (flight squadrons)	3	3	3
Air Reconnaissance Units (flight squadrons)	1	1	1
Air Transport Units (flight squadrons)	3	3	3
Early Warning Units (flight squadrons)	1	1	1
High-Altitude Surface-to-Air Missile Units (anti-aircraft groups)	6	6	6
Major Equipment			
Combat Aircraft	430	414	415

Source: Japan Defense Agency, Defense of Japan, 1989.

planners, Japanese defense officials have concluded that, Kremlin statements notwithstanding, Soviet military power in the Far East has not diminished. They note that Moscow's apparent cutbacks in military forces and weaponry in the region are offset by qualitative improvements in equipment and the deployment of technologically sophisticated aircraft carriers (see JEI Report No. 40B, October 20, 1989).

The budget for the final year of the current five-year defense plan funds some important additions to Japan's defensive arsenal. Specifically, the Ground Self-Defense Force has been allocated money to obtain, among other things, 30 Type-90 tanks, 44 155mm howitzers, 16 SSM-1 surface-to-air guided missiles, 8 AH-1S antitank helicopters and 9 Type-89 armored fighting vehicles. The Maritime Self-Defense Force plans to acquire a second 7,200-ton destroyer equipped with the sophisticated Aegis air defense system, a submarine, 8 P3-C Orion antisubmarine patrol planes, 11 antisubmarine patrol helicopters, 1 minesweeper and other equipment. The Air Self-Defense Force's equipment list includes 10 F-15J Eagle fighter aircraft, 19 T-4 fighter aircraft trainers, one group of Patriot surface-to-air missiles, two E2C early warning planes and two CH-47J transport helicopters.

A significant component in the FY 1990 spending plan is the approximately Y104 billion ($693.3 million) in funding for military research and development. This encompasses monies for the project with the United States to develop and build Japan's new FSX fighter aircraft, a replacement for the nearly 15-year-old F-1. Delays in getting the project off the ground, however, may prevent the ASDF from receiving its first FSX in the fall of 1997 as originally planned (see JEI Report No. 30A, August 3, 1990). This may affect how well Japan performs its 1,000 nautical-mile defense mission. The F-1 was designed primarily for low-altitude support of Japanese ground forces. The FSX, with its sophisticated electronics, more powerful engine and larger fuel tank (among other features), will improve upon the F-1's ground support functions as well as enable the new aircraft to perform long flights over water and, if necessary, engage in aerial combat. Japanese defense planners, in considering Japan's defense needs for the 1990s, about five years ago concluded that a replacement for the F-1 was needed in light of military intelligence estimates of a qualitatively improved Soviet military capability in the region (see JEI Report No. 21A, May 26, 1989).

One area where Japan still may be short of the goals of the National Defense Program Outline at the end of the current buildup plan is enlistment. Some reports maintain that the Self-Defense Forces are an estimated 25,000 people under a targeted troop strength of 180,000. One consequence is that many of Japan's warships consistently are listed as being in a state of "half-readiness" due to crew shortages.[2]

The SDF's recruitment problems appear to reflect the postwar generation's pacifist orientation and general ambivalence about the military. As Figure 2 indicates, public interest/disinterest in the SDF and defense issues represents about a 50-50 split. Defense officials also suggest that difficulties in attracting young people, particularly talented individuals, correspond to

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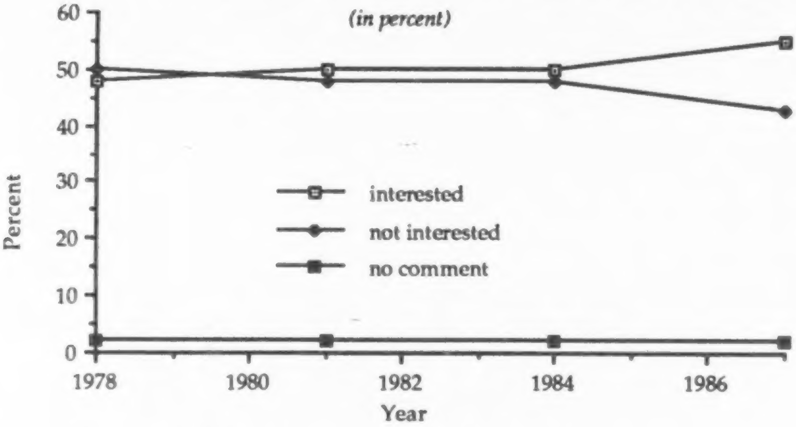
[2] David E. Sanger, "For Japan's Military, Some Second Thoughts About Where the Enemy Is," New York Times, July 29, 1990.

Figure 2: Japanese Interest in SDF and Defense Issues



Source: Japan Defense Agency, Defense of Japan, 1989

Japan's economic success. Opportunities in the business sector appear far more lucrative and professionally satisfying to young adults than the low-paying jobs and often less than satisfactory living conditions affiliated at times with a military career. An estimated 15 percent of the 425 graduates of the National Defense Academy, for example, announced this year that they would turn down their commissions to accept higher paying, more upwardly mobile jobs with major defense contractors, such as Mitsubishi Heavy Industries, Ltd., Toshiba Corp. and NEC Corp.[3]

In an effort to bolster troop strength the SDF has begun to employ some of the marketing techniques used by U.S. armed forces recruiters. JDA also has attempted to earmark more funds to improve living and working conditions for SDF personnel. In the FY 1990 budget negotiations, for example, the defense agency was able to convince MOF to reinstate funding initially red-lined by finance officials for lump-sum payments for SDF retirees.

Host-Nation Support - While bolstering Japan's military capabilities garners most of the attention in the current five-year defense buildup plan and the bulk of JDA's annual budget, an important secondary objective of both is to cover an increased part of the costs of U.S. forces stationed in Japan. The FY 1990 budget, for example, allocates Y320 billion ($2.1 billion) toward this end compared to a FY 1985 level of Y280 billion ($1.9 billion).

Under the U.S.-Japan Mutual Security Treaty Japan provides base facilities for American forces. While representing the U.S. commitment to Japan's security, the bases also are critical to speedy U.S. deployment in the Asian Pacific arena. Tokyo's spending in this area amounts to approximately 40 percent of the $6 billion annual cost of maintaining U.S. forces at over 100 military facilities in the Japanese archipelago.

[3] Ibid.

American legislators who charge that Japan should be sharing more of the defense burden given its economic strength have zeroed in on host-nation support, contending that Tokyo should bear 100 percent of the direct costs of maintaining U.S. troops on Japanese soil. Tokyo has countered that these demands exceed what it legally may do under the 1960 Status of Forces Agreement, which stipulates the costs that the United States and Japan each should bear to support the American troop presence (see JEI Report No. 38A, October 6, 1989). Nevertheless, Japanese officials have promised in bilateral defense discussions to provide increased support for U.S. forces within the legal limits. In the current fiscal year, for example, JDA plans to assume more of the burden of maintaining U.S. forces in Japan by paying for such things as fringe benefits for Japanese workers employed on U.S. bases -- an expense that, in Tokyo's eyes, will not exceed the SOFA constraints.

With the completion of the FY 1986-FY 1990 defense buildup program Japan's ability to prevent an armed invasion of its home islands will have improved dramatically since officials penned the National Defense Program Outline in 1976. In terms of sheer quantity SDF equipment and personnel still pale in comparison to what the Soviet Union reportedly has targeted toward Asia (see Table 3). The total of 629 ASDF and MSDF combat aircraft, for example, is less

Table 3: Soviet Forces in Asia

Ground Forces	
Maneuver Divisions	48
Artillery Divisions	3
Tanks	11,500
Artillery	12,500
Helicopters	1,100
Pacific Fleet	
Total Ships, Vessels and Craft	875
Ballistic Missile Submarines*	26
Attack Submarines	94
Carriers	2
Cruisers	11
Destroyers	8
Frigates	56
Minor Combatants	202
Amphibious	21
Support and Miscellaneous Craft	455
Combat Aircraft and Helicopters	345
Naval Infantry Divisions	1
Air Forces	
Bombers	215
Fighters/Attack Aircraft	890
Air Defense Fighters	590

*This is a combined total for conventionally powered and nuclear-powered ballistic missile submarines.

Source: Department of Defense

than one-third the estimated 2,040 combat aircraft Moscow has in the Far East arena. But matching the Soviet Union's military capability has never been the intent of a country whose constitution effectively reins in defense spending and prevents the development of a power projection capability. The outline, in fact, clarifies that Japan's military should be sufficiently strong to repel a "limited and small-scale invasion." The statement also emphasizes continued "qualitative improvements and reinforcements [to enable the SDF] to cope with changes in the technological standards in other countries."

Judged by this standard, the adequacy of Japan's defense capabilities may be better determined by considering how its weapons systems have been progressively modernized so as to complement and/or reinforce the U.S. military presence in the region. On this point the Pentagon gives Tokyo high marks. According to Henry S. Rowen, assistant secretary of defense for international security affairs, the Department of Defense regards what Japan has done thus far to realize its 1,000 nautical-mile self-defense goal through expanding and upgrading its forces as "basically sound."

Elaborating on this assessment, U.S. defense officials have noted, for example, that the FY 1986-FY 1990 defense program will provide the MSDF with more P3-C antisubmarine patrol aircraft than are available to the U.S. Pacific fleet, thereby enabling Japan's navy to provide even more effective sealane protection. The Pentagon also has applauded JDA's decision to initiate procurement during the current program of the better-performing Patriot surface-to-air missile to replace outdated Nike missiles. The phaseout of the F-4EJ interceptor aircraft in favor of the newer F-15 fighter interceptor is another example of how Tokyo, through qualitative improvements, has enhanced its overall military capabilities while staying true to its self-defense mission, analysts say.

But defense planners in both countries agree that even with completion of the FY 1986-FY 1990 military buildup program and attainment of most of the outline's objectives, Japan's military still will not be able to provide an effective defense out to 1,000 nautical miles. As suggested above, the FSX fighter aircraft may begin to rectify this problem toward the end of this decade. JDA has some other ideas as to how Japan's defense capabilities can, and should, be improved to address the global security environment of the 1990s.

Improvements in East-West Relations and Future Japanese Defense Plans

With the FY 1986-FY 1990 program buildup drawing to a close, Japanese defense planners began in the summer of 1989 to pull together proposals for a follow-up five-year plan. Many analysts consider the next steps crucial since most of the objectives set by the National Defense Program Outline will have been attained. These achievements, it is said, put defense officials in the position of having to develop a new conceptualization of Japan's security needs. Their job is doubly difficult, however, because of the improvement in U.S.-Soviet relations and the planned pullback of American forces from Japan and other Asian locations. Also complicating the deliberations is Japan's emergence during the past decade as a major economic power.

Discussions this summer by Japan's National Security Council, a panel composed of the prime minister and selected cabinet officials that deliberates defense-related issues, suggest that the current SDF modernization program will be continued through FY 1995. Echoing arguments by which JDA justified its budget request for FY 1990, a NSC report released in July underscored the necessity of seeing through the consequences of the historical changes taking place worldwide. Despite impressive breakthroughs in Europe, arms control is not yet progressing similarly in Asia, and regional instability is possible, the panel emphasized. NSC members therefore pushed for funding of several advanced systems in addition to the FSX within the framework of a new medium-term plan. For the most part this hardware would be purchased off-the-shelf from the United States. On the NSC list are: AWACS (airborne warning and control system) aircraft, the multiple-launch rocket system, tanker refueling aircraft and Aegis systems.

Continuing present efforts to attract talented individuals to the military, the drafters of the NSC report also urged that money be appropriated to establish a new 2,000-person headquarters for gathering and analyzing intelligence data. General improvements in living and working conditions for SDF members would bring the total requested for the FY 1991-FY 1995 plan to roughly Y23.4 trillion ($156 billion) compared to the Y18.4 trillion ($122.7 billion) budgeted for the FY 1986-FY 1990 program. (No additional funding is anticipated for Strategic Defense Initiative studies, which also have come under closer scrutiny in Congress in light of changing security needs and U.S. fiscal problems.)

A Mid-Term Plan or Flexibility? - While the Pentagon generally appears satisfied that the new defense plan will assure continued improvements in Japan's self-defense capabilities, domestic critics have been severe. Citing Washington's intention in the next three years to reduce by one-tenth the American forces stationed in Japan (see JEI Report No. 9B, March 2, 1990), opposition parties have argued that the upcoming defense program should be reevaluated with an eye toward similarly reducing Japan's military power. Along with certain members of the ruling Liberal Democratic Party, they have suggested that the length of the new program be scaled back to only three years and/or that the plan be subject to annual reviews to allow the government greater flexibility in adapting Japan's defense efforts to changes in East-West relations. Further action on a comprehensive defense plan for the next five years has been suspended basically due to this continuing dissension over the nature and the duration of the program.

Doing without a multiyear defense framework for the time being actually might be a good idea, according to some analysts, who say that Japanese policymakers need more time to contemplate what exactly constitutes a threat to the home islands. The U.S-Japan Mutual Security Treaty -- as well as the NATO (North Atlantic Treaty Organization) alliance -- originally were constructed to deter and contain the Soviet Union. However, the economic and the political reforms sweeping through the Soviet bloc and the planned German reunification are not by-products of the 1950s-era communist regime that affected a bipolar power structure. Hints from Moscow that Soviet President Mikhail Gorbachev may use his visit to Tokyo next spring to launch a new "Asian disarmament initiative" also suggest that the Soviet Union may no longer be as threatening to Japan as it was during the Cold War period.

Prime Minister Toshiki Kaifu and other LDP members anxious for a diplomatic breakthrough with Moscow maintain that recent geopolitical developments reflect a lessening of the Soviet threat. These developments, they maintain, should be reflected in Japanese defense planning. However, JDA, in concurrence with the Pentagon, believes this line of thinking is premature based on intelligence estimates of Soviet troops and weaponry in the Far East. Given the history of animosity between Tokyo and Moscow (see JEI Report No. 36A, September 23, 1988) and the importance Japan places on its defense relationship with the United States, Tokyo may not readily follow its European allies and make substantial cuts in its Soviet-targeted troops and weaponry. A year-by-year defense program would provide defense planners with the flexibility to augment or cut back military capabilities depending on developments in Japanese-Soviet relations or East-West diplomacy in general.

The ad hoc approach also may be the best route to go in light of the Middle East crisis, these same analysts say. Iraq's early August invasion of Kuwait essentially has forced defense planners in Tokyo as well as Washington and other Western capitals to deal with the global implications of regional conflicts -- conflicts that do not involve a confrontation with the Soviet Union or nuclear war. Although developments in the Persian Gulf do not directly threaten the Japanese islands, they could indeed cause harm to Japan's economy given its dependence on oil from this region.

Tokyo already has come under intense international pressure to broaden the interpretation of its constitutional constraints on the role of the military so that it could contribute to the Western-Arab defense effort in the Persian Gulf. Depending on how Japanese government and political leaders grapple with this issue, JDA policy planners may find that the self-defense mission pursued under the deterrence-oriented U.S.-Japan treaty framework is neither appropriate nor effective in responding to a crisis that does not involve the threat of a Soviet attack. Again, supporters of defense planning flexibility say, a multiyear plan would not allow Tokyo to fine-tune defense needs according to changes in the international environment.

FY 1991 Budget Negotiations - The imperatives of the annual budget-writing process, however, have forced Tokyo to come to terms with what it wants to do in the defense area at least in FY 1991. In a late July meeting with Finance Minister Ryutaro Hashimoto JDA director general Yozo Ishihara lobbied for a 6.3 percent increase in defense funding for the upcoming fiscal year. His main arguments revolved around continuing concerns about the Soviet threat to Asian Pacific security and the decline in the yen's value against the dollar since late 1988, which has pushed up the cost of acquiring American-made equipment.

Although effective in FY 1990 budget negotiations, Mr. Ishihara's arguments did not sway MOF this time. The Finance Ministry, backed by Prime Minister Kaifu, insisted that continued defense spending increases in the 6 percent range would be "unacceptable" given improved U.S.-Soviet relations and budget realities. At most the defense budget will go up 5.8 percent next April, the lowest year-to-year ceiling on increases in 30 years.

Mr. Kaifu's support for scaled-back growth in defense spending helped to nail the lid on the defense agency's hopes of realizing a 6.3 percent hike for the upcoming budget year. The July 1990 summit of the major industrial countries apparently affected the prime minister's assessment of the security threat posed by the Soviet Union. Mr. Kaifu advised JDA in late July to take into account "changes in the international situation" in drawing up the FY 1991 defense spending plan. "[T]he perception of the international situation by the European countries has changed much," the prime minister was quoted as telling defense planners after the Houston meeting. "I hope future [Japanese defense] policy and [defense] white papers will be based on this point," he reportedly stated. Japanese political analysts have offered a less formal translation of the message the prime minister evidently was trying to convey: "How can I agree to such a large increase in the defense budget while our Western allies are cutting theirs?"

The 1990 defense white paper -- which, judging by previous years, should have been released by now -- has yet to be issued, reportedly because of internal disagreements about how to portray the Soviet factor in Japan's security scenario. Mr. Kaifu, anxious for a successful summit with Mr. Gorbachev next spring (probably in April), reportedly instructed JDA to compile a white paper that would reflect a "relaxation of international tensions." JDA officials do not wholly embrace this view since, as noted, they have found no hard evidence to date of a reduction in the quantity or the quality of Soviet military capabilities in the Far East. The defense agency, however, is not about to ignore the prime minister on this issue.

JDA also apparently is reconciled to getting less money than it sought for FY 1991. Its Y4.4 trillion ($29.3 billion) budget proposal emphasizes facilities and personnel rather than frontline weaponry. Roughly Y1.7 trillion ($11.3 billion), about 39 percent of the total, is earmarked for personnel expenditures, including approximately Y38 billion ($253.3 million) for the construction and the renovation of SDF living quarters.

In the equipment area JDA hopes to procure an Aegis-equipped destroyer at Y149.6 billion ($997.3 million), 34 Type-90 tanks at Y1.2 billion ($8 million), 11 F-15 fighter aircraft at Y9.5 billion ($63.3 million) and a package of Patriot surface-to-air missiles at Y110.9 billion ($739.3 million), among other items. In mid-August meetings at the Pentagon Kazuo Fujii, head of JDA's policy bureau, informed Assistant Secretary of Defense for International Security Affairs Rowen, that it would be difficult in the immediate future for the defense agency to acquire some of the advanced, big-ticket hardware that it wants, such as AWACS and the multiple-launch rocket system. Mr. Rowen emphasized the importance of procuring these advanced systems. Japan needs the U.S.-made AWACS, MLRS and other high technology equipment to ensure that its defense capabilities remain up to par, he reportedly stressed. Washington also is concerned that, should Japan decide to invest in this type of hardware, it might opt for the more time-consuming and expensive route of developing the systems indigenously or buying similar equipment from third parties, either of which alternatives could lead to interoperability problems.

Despite Mr. Fujii's discouraging message regarding the purchase of advanced, big-ticket hardware, Japanese defense experts are not too concerned about JDA's FY 1991 spending priorities. Funding for weapons procurement during the first year of a multiyear plan typically is relatively low. This is because equipment purchases have a two- to five-year budgetary impact (that is, the bill for an order placed in FY 1991 probably will not come due until FY 1993 or FY 1994). Thus, defense analysts in Japan believe that the fate of advanced weapons purchases will be known better after next year's preliminary round of budget discussions.

If JDA does order AWACS or other expensive systems in FY 1992, it would be harder for MOF to trim the growth in defense spending in later years. Thus, from a budgetary standpoint, JDA might fare better in future funding battles if it were to contract for big-ticket items as soon as possible. With a multiyear defense program, however, Tokyo might be better able to finesse Washington's hardware sales pitch by writing in plans to procure sophisticated weaponry toward the end of the five-year period. But these considerations may be moot in light of continuing changes in the Kremlin's thinking and behavior as well as new uncertainties created by the Middle East crisis, which have prompted Tokyo to reconsider its commitment to a new mid-term plan.

Middle East Crisis and Japan's Defense Role

Iraq's invasion of Kuwait has complicated further Tokyo's consideration of how to adapt its defense policy and programs to the post-Cold War security environment. In the eyes of the international community Japan's bid to be a global power has attendant responsibilities. Although Baghdad's actions do not constitute a direct threat to Japan -- like, say, a Soviet invasion would -- the United States and other Western allies nevertheless have made it clear that the Japanese government is expected to take actions to protest Iraq's violation of the rules of international diplomacy.

Tokyo joined the international trade embargo of Iraq and Kuwait relatively quickly -- a move that is bound to cause some harm to the Japanese economy given its dependence on these two countries for approximately 10.6 percent of its imported oil (see JEI Report No. 31B, August 10, 1990). But this action was not enough, members of the Western alliance said. Japan should shoulder more of the burden of defending it oil lifeline and upholding codes of international conduct, they said.

Tokyo heard similar criticism at the height of the Iran-Iraq war in 1987 and 1988 after the United States and some European nations committed forces to the Persian Gulf to keep oil-shipping lanes open. Citing the constitutional constraint against the dispatch of troops abroad, the Japanese government instead provided a precision navigation system, $10 million toward United Nations peace efforts, additional economic assistance to the region and increased host-nation support to offset U.S. costs in the Persian Gulf effort (see JEI Report No. 39B, October 16, 1987).

When Japanese officials suggested that this same kind of nonmilitary assistance probably would comprise Tokyo's response to the current Middle East crisis, key American officials came down hard on Japan for its reliance on "checkbook diplomacy" (see JEI Report No. 35B, September 14, 1990). The issue underscores the inherent conflict between superpower assistance in an international crisis and Tokyo's constitutional limits on military involvement overseas. One Bush administration official pointedly called the Persian Gulf crisis a litmus test of future U.S.-Japan relations. A failure by Japan to take concrete measures in the Middle East crisis, "such as unconditionally sending Japanese cargo aircraft, ships and minesweepers, will endanger the U.S.-Japan global partnership," he said.

Constitutional Quandary - Japanese government and political officials, already weighing future defense scenarios, have been forced to look beyond this issue and consider whether current global conditions have eclipsed the suitability of the postwar legal constraints on the dispatch of military power overseas. The pivotal point in their eyes is whether Article 9 of the constitution needs to be reinterpreted in a post-Cold War world where Japan holds considerable economic power. Numerous Japanese scholars and foreign policy experts see such a need. Seizaburo Sato, a political science professor at Tokyo University and a prominent LDP adviser, maintains that the Middle East crisis augers for a change in Japan's security policy. ". . . [A] defense-only stance will not enable Japan to secure its safety and fulfill its international responsibility as the need to prevent aggression of the Iraqi type increases even though the immediate Soviet threat declines," he stated.[4] Even before the Iraqi invasion, Terumasa Nakanishi of Shizuoka University, in an article with former Reagan administration defense official Fred C. Ikle, proposed that Japan's "isolationist defense strategy" would not serve the nation well in the 1990s.[5]

But the Japanese public still reacts quite strongly to the idea of sending troops and military hardware abroad. As the Iran-Iraq war was approaching its height in the fall of 1987, the government of then Prime Minister Yasuhiro Nakasone decided that sending MDF minesweepers to the Persian Gulf to protect Japan's oil supply routes would constitute an act of self-defense. However, opposition by then chief cabinet secretary Masaharu Gotoda kept the minesweepers in their home ports; Mr. Gotoda argued that the MSDF minesweepers' availability might be interpreted as, or lead to, the use of force. Mr. Kaifu appears to face similar opposition within the LDP today. The difference now is that while some ruling party members genuinely are concerned about constitutional questions, others reportedly covet the prime minister's newfound public popularity and do not want to give him another issue that will make him look like a bold leader.

Interestingly, Mr. Kaifu has received some opposition party support for a more active Japanese role in the Middle East. Keigo Ouchi, chairman of the Democratic Socialist Party, suggested in mid-August that Japan should study the possibility of sending SDF personnel to the Persian Gulf. However, Takako Doi, chairwoman of the Japan Socialist Party stated in a meeting with Mr. Kaifu at about the same time that her party strongly opposes any use of Japanese military or nonmilitary personnel in a war situation outside the vicinity of the home islands. (The JSP platform calls for neutrality in defense, including the abolition of the U.S.-Japan Mutual Security Treaty.)

Tokyo University's Sato charges that the JSP's thinking reflects an unwillingness to do "dangerous, dirty and hard work." The Socialists and others who embrace an outdated interpretation of the constitution express a point of view that is "selfish and will not be accepted by the world," he argued.[6] While not articulating quite such strong views, Mr. Kaifu apparently agrees that a bolder approach may be needed -- but not so bold as to threaten the remaining year of his tenure.

[4] Seizaburo Sato, "Japan's New Responsibilty," The Japan Times, August 27, 1990.

[5] Fred C. Ikle and Terumasa Nakanishi, "Japan's Grand Strategy," Foreign Affairs, Summer 1990, pp. 81-95.

[6] Sato, op. cit.

The prime minister has urged streamlining laws to allow Japan to act quickly in future international emergencies. According to Japanese government officials, a special session of the Diet could be convened this fall to consider legislation that would allow a broader interpretation of nonmilitary assistance. For example, a 1987 law that allows the government to send nonmilitary personnel abroad to areas stricken by natural disaster might be amended to further clarify that Tokyo may dispatch such individuals for multilateral peacekeeping efforts. At the end of August Mr. Kaifu proposed enacting a separate "United Nations Peace Cooperation Law" to give Japan more flexibility to participate in U.N.-sponsored peace initiatives. Alternatively, the prime minister is said to support revision of the Self-Defense Forces Law, perhaps to allow SDF personnel and equipment to be used abroad in U.N.-sponsored peacekeeping activities. Mr. Kaifu has yet to reveal his plans on the latter proposal, perhaps to allow more time to gauge the degree of public support for allowing the interpretation of Japan's self-defense mission to be stretched.

"Checkbook Diplomacy" and Japan's Defense Role - Prime Minister Kaifu unveiled Japan's long-awaited package of measures to support multinational efforts to resolve the Middle East crisis four weeks after Iraq's invasion of Kuwait. While the measures fell short of what Washington had hoped Tokyo would offer, they appeared to represent the best that Mr. Kaifu could muster given still strong domestic pressures (see JEI Report No. 35B, September 14, 1990). The Japanese leader appeared acutely aware that Washington was growing impatient and exasperated with Tokyo's delays in drafting a plan. To those Japanese who are uncomfortable with the nature and the timing of the assistance package, Mr. Kaifu said, "If Japan's response is delayed and the world gets the impression that Japan does nothing for peace in the region, when its own interest is at stake, Japan's future will be lost."

Tokyo's subsequent problems in implementing the plan have irritated Washington further and appear to give credence to Japan critics who charge that this country's Pacific ally lacks the will to assume major power responsibilities. But despite the follow-up problems, there seems to be some understanding among senior government officials and politicians that Japan no longer can simply "write a check" to protect its economic self-interest or passively ride out a storm under the U.S.-Japan defense "umbrella." Changing global alignments require a more activist diplomacy.

Prime Minister Kaifu, in an article in the fall issue of Foreign Affairs that he apparently wrote before the Iraqi invasion, argues for just such a change. Mr. Kaifu calls on Japan to pursue a "motivated foreign policy," wherein it would apply its economic and technological strength to help create a "new framework for international relations." Critics certainly could argue that the prime minister has not exactly ushered in this new era with his handling of the Middle East crisis. What may be more important, however, is that the highest levels of government apparently recognize that Japan is expected to play a higher-profile political role in global affairs and that the breakdown of the Cold War structure allows greater foreign policy autonomy.

Mr. Kaifu's next important challenge -- and opportunity to demonstrate that his government is willing to do more than write checks -- will be in ushering through the Diet legislation that would authorize Japanese financial support for, and/or participation in, U.N.-sponsored peacekeeping operations. Success could create important new diplomatic opportunities for Tokyo and lead to a reinterpretation of Japan's self-defense mission, both of which may have a bearing on future defense plans.

Outlook: A New Global Policy?

Political analysts on both sides of the Pacific contend that it is incumbent on Japan to reevaluate its global strategic policy in light of recent international developments.[7] Policy discussions surrounding Mr. Gorbachev's visit to Japan next spring and Saddam Hussein's actions in early August appear to have initiated this review. Given the nature of decisionmaking in Japan, however, deliberations on this topic no doubt could proceed at what Western observers may regard as an agonizingly slow pace.

It is highly unlikely that such a review would lead to an abrogation of the U.S.-Japan Mutual Security Treaty or even a radically altered bilateral defense relationship -- regardless of the outcome of the Soviet leader's trip. As Mr. Sato of Tokyo University points out, the Soviet Union will continue to be a military superpower for the foreseeable future so the need to maintain an "anti-Soviet deterrent" has not disappeared.[8] But even if the Kremlin does institute significant military cutbacks in the Far East, the bilateral defense arrangement will continue to play an important role for Japan's security relations with other regional powers, such as China, or with politically unstable countries such as the Philippines and Cambodia.

As the Persian Gulf crisis has driven home, Tokyo simply may have to come to grips with the fact that the international community expects more -- politically, militarily and financially -- from a country with Japan's economic prowess. While staying true to its pacifist constitution, the Japanese government may have to redefine "self-defense" so that Japan may play a role befitting a global power in helping to resolve international emergencies.

This strategic "soul-searching" will not be reflected in significantly higher Japanese defense spending or weapons procurement in the near future; budgetary pressures, domestic and regional sensitivities and the Cold War thaw will continue to rein in the growth of defense spending for at least the next two years. Japanese defense planners may be content to go without a three- or five-year blueprint until Moscow's policy toward Asia is better known and the situation in the Persian Gulf stabilizes. Should the conflict in the Middle East become protracted, however, Tokyo may have no choice but to rethink its defense and military-spending priorities.

[7] Ikle and Nakanishi, op. cit., p. 95.

[8] Sato, op. cit.

For further information, contact Barbara Wanner.

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The views expressed in this report are those of the author and do not necessarily represent those of the Japan Economic Institute.

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JAPAN · ECONOMIC · INSTITUTE

JEI REPORT

A Two-Part Report: A and B

NO. 35B
September 14, 1990

IN THIS ISSUE:

Japan Unveils Assistance Plan For Middle East ... 1

Washington Reacts To Japanese Gulf Measures 4

BOJ Lifts Discount Rate 6

FY 1991 Budget Requests Set Record 8

Japan Unveils Assistance Plan For Middle East

In a nationally televised press conference August 29 Prime Minister Toshiki Kaifu unveiled a much-awaited package of monetary and nonmilitary support for multinational efforts aimed at resolving the crisis stemming from Iraq's invasion of Kuwait. Although these actions still fall short of what the United States believes Japan can -- and should -- do (see following article), Tokyo's response to the Middle East situation may represent a transformation in Japanese foreign policy -- its "heisei reformation" in Mr. Kaifu's words -- characterized by a more engaged diplomacy.

In announcing the six-point plan, the prime minister appeared acutely aware that the nearly month-long delay in deciding how Tokyo would assist the U.S.-led multinational operation in the Middle East was attracting critical attention in Washington. Japan had joined its Western allies August 5 in slapping economic sanctions on Iraq to protest Baghdad's invasion of Kuwait three days earlier. But as various nations committed military or financial support, political analysts in the United States, Japan and elsewhere began to criticize Tokyo for not moving quickly to assume more of the burden for defending its Middle East oil lifeline. The Japanese government blamed the delays on problems it was having in developing a response that would not exceed the constraints of its "peace constitution" (see JEI Report No. 34B, August 31, 1990).

Mr. Kaifu, however, also sensed that large numbers of Japanese would be uncomfortable with the nature and the timing of the August 29 assistance package. He reminded them, "If Japan's response is delayed and the world gets the

FY 1991 Budget Requests Set Record

Responding to a relaxation of fiscal austerity, Japanese government agencies have submitted FY 1991 general account budget requests totaling a record Y71.1 trillion ($474.1 billion at Y150=$1.00), a 7.4 percent gain over the money sought for the current fiscal year (see Table 1). Potentially sharp increases in nondiscretionary spending plus selective rises in discretionary outlays point to the biggest jump in initially planned expenditures since the early 1980s. That outcome is almost guaranteed even though most requests no doubt will be pared down during negotiations between the Ministry of Finance and other agencies on a draft budget, due in December. One major reason is because Tokyo has said it will increase funding for public works to follow through on its commitments in the Structural Impediments Initiative talks with the United States.

Table 1: Summary of FY 1990 and FY 1991 General Account Budget Requests

(in billions of yen and percentage change)

	FY 1990	FY 1991	Change
Discretionary Expenditures	Y35,373.1	Y36,942.7	4.4%
Debt Service	14,288.6	16,322.9	14.2
Local Government Transfers	15,275.1	16,550.2	8.3
Infrastructure Investment*	1,300.0	1,300.0	0.0
Total	66,236.8	71,115.8	7.4
Fiscal Investment and Loan Program	34,572.4	42,500.0	22.9

*Funded by the sale of government-held shares of Nippon Telegraph and Telephone Corp.

Source: Ministry of Finance

In line with the cabinet's earlier budget guidelines (see JEI Report No. 30B, August 3, 1990), discretionary spending requests are up 4.4 percent to Y36.9 trillion ($246.3 billion) (see Table 1). Highlights include requests for Y1.2 trillion ($8 billion) for "improving the quality of life;" the cabinet had recommended Y200 billion ($1.3 billion) for this purpose. Tokyo committed itself in the final SII report to spending about Y430 trillion ($2.9 trillion) over the next decade for public works and other projects aimed at raising the standard of living (see JEI Report No. 26B, July 6, 1990). To greater or lesser degrees the ministries have responded; only the Imperial Household submitted a lower budget request than last year (see Table 2). The Foreign Ministry requested Y455.3 billion ($3 billion) for foreign aid, a solid 9.7 percent gain. Included in this package is Y150 million ($1 million) to promote economic reform in the Soviet Union, an unprecedented request by MOFA. The defense spending proposal tops Y4.4 trillion ($29.3 billion), which translates into a 5.8 percent gain, the smallest since FY 1981. Yozo Ishikawa, head of the Japan Defense Agency, said the modest request reflected the "current world situation and the nation's financial situation."

Table 2: FY 1990 and FY 1991 Budget Requests by Agency

(in billions of yen and percentage change)

	FY 1990	FY 1991	Change
Imperial Household	Y6.5	Y5.9	-8.6%
Diet	92.0	94.1	2.3
Judiciary	257.4	261.3	1.5
Board of Audits	12.0	12.2	1.8
Cabinet	12.7	13.4	5.5
Prime Minister's Office	7,825.9	8,081.8	3.3
Defense Agency	4,159.3	4,402.3	5.8
Ministry of Justice	455.1	465.6	2.3
Ministry of Foreign Affairs	533.9	580.2	8.7
Ministry of Finance	1,421.5	1,450.5	2.0
Ministry of Education	4,798.8	4,944.2	3.0
Ministry of Health and Welfare	11,565.2	12,215.6	5.6
Ministry of Agriculture, Forestry and Fisheries	2,509.4	2,539.1	1.2
Ministry of International Trade and Industry	726.3	788.5	8.6
Ministry of Transportation	813.2	822.4	1.1
Ministry of Posts and Telecommunications	26.5	27.6	4.2
Ministry of Construction	3,761.6	3,885.1	3.3
Ministry of Home Affairs	68.2	68.3	0.1

Source: Ministry of Finance

Mr. Ishikawa's concern for the nation's finances seems curious given the Japanese economy's strong showing over the past several quarters and expectations of continued solid growth. His concern is less puzzling in view of an outstanding national debt expected to reach Y164 trillion ($1.1 trillion) by the end of March 1991 and rising Japanese interest rates. The Finance Ministry had projected earlier this year that debt service costs would rise only 5.7 percent in FY 1991 (see JEI Report No. 26A, July 6, 1990). Now financial planners have penciled in a whopping 14.2 percent jump for debt service in the initial-request budget. The discrepancy is blamed on the upward drift in interest rates even before the latest Bank of Japan discount rate hike (see preceding article). MOF estimates that even if rates remain at current levels, the government will pay an additional Y12 trillion ($80 billion) to float new bonds planned for FY 1991.

The other major nondiscretionary spending item -- transfers to local governments -- stems from a mandate that the central government return a fixed percentage of certain tax revenues to local administrations. The strong growth in tax receipts projected for FY 1991 will force Tokyo to allocate 8.3 percent more to this item. Interestingly, the requested general account budget still shows Y1.3 trillion ($8.7 billion) in public works spending financed through the sale of government-held shares of Nippon Telegraph and Telephone Corp., even though last year's auction of NTT stock was scrapped and this year's sale recently was canceled. If the Tokyo Stock Exchange remains depressed (and NTT shares remain well below anticipated levels), it is not clear whether MOF can rely on this "nondiscretionary" source of income in future years.

Initial requests for the Fiscal Investment and Loan Program, the capital budget, also show a sharp increase. Except for the Housing Loan Corp., every government organization that gets FILP money boosted its request for FY 1991. The upsurge reflects both Tokyo's SII commitment (a significant share of FILP monies fund public works and housing loans) and Tokyo's pledge to increase foreign aid. (Two of Japan's major foreign aid organizations, the Japan Development Bank and the Overseas Economic Cooperation Fund, receive FILP funding).

Although it appears that Tokyo has eased its austere fiscal stance to meet international commitments, the budget requests are only the second step in a lengthy process. The ruling Liberal Democratic Party still must strike a compromise with opposition parties on how to amend the controversial 3 percent general consumption tax. This issue delayed passage of the general account budget for the past two years and could do so again next year.

Jon Choy

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The views expressed in this report are those of the authors and do not necessarily represent those of the Japan Economic Institute.

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JAPAN ECONOMIC INSTITUTE

JEI

REPORT

A Two-Part Report: A and B

NO. 36A

September 21, 1990

STATISTICAL PROFILE

JAPAN'S ECONOMY IN 1989
AND
INTERNATIONAL TRANSACTIONS OF JAPAN AND THE UNITED STATES IN 1989

Japan Economic Institute 1000 Connecticut Avenue, N.W., Washington, D.C. 20036 202-296-5633

Table of Contents

Table 1: Japan's Gross National Product at 1980 Constant Prices, 1985-1989 1
Table 2: Major Interest Rates in Japan, 1985-1989 3
Table 3: Money Supply in Japan, 1985-1989 3
Table 4: Japan's General Account Expenditures (Revised), FY 1985-FY 1989 4
Table 5: Japan's Discretionary General Account Spending (Revised), FY 1985-FY 1989 5
Table 6: Japan's General Account Revenues (Revised), FY 1985-FY 1989 5
Table 7: Uses and Sources of Japan's Fiscal Investment and Loan Program Outlays (Initial), FY 1985-FY 1989 6
Table 8: Japan's Industrial Production Index by Sector, 1985-1989 7
Table 9: Japan's Index of Industrial Production by End-Use Classification, 1985-1989 7
Table 10: Japan's Index of Producers' Inventories of Finished Goods, 1985-1989 8
Table 11: Japan's Index of Consumption of Materials, 1985-1989 8
Table 12: Japan's Index of Inventories of Materials, 1985-1989 9
Table 13: Japan's Index of Manufacturing Operating Rates, 1985-1989 9
Table 14: Residential Construction Starts in Japan, 1985-1989 9
Table 15: Japan's Labor Force Survey, 1985-1989 10
Table 16: Employment Index of Regular Workers in Japan, 1985-1989 10
Table 17: Nominal Wage Index of Regular Workers in Japan, 1985-1989 11
Table 18: Average Monthly Wages of Manufacturing Employees in Japan by Industry, 1985-1989 11
Table 19: Index of Labor Productivity in Japan, 1985-1989 12
Table 20: Japan's Consumer Price Index, 1985-1989 12
Table 21: Japan's Wholesale Price Index by Industry, 1985-1989 13
Table 22: Japan's Wholesale Price Index by End-Use Classification, 1985-1989 13
Table 23: Japan's Global Balance of Payments, 1985-1989 14
Table 24: Japan's Balance of Payments with the United States, 1985-1989 15
Table 25: Japan's Exports and Imports in Dollar Terms, 1985-1989 16
Table 26: Japan's Exports and Imports in Yen Terms, 1985-1989 16
Table 27: Japan's Export and Import Quantum (Volume) Indexes, 1985-1989 17
Table 28: Japan's Export and Import Yen-Based Price Indexes, 1985-1989 17
Table 29: Yen-Dollar Exchange Rate Used to Convert Customs Clearance Trade Data, 1985-1989 18
Table 30: Yen-Dollar Exchange Rate on Tokyo Foreign Exchange Market, 1985-1989 18
Table 31: Japan's Exports by Major Market, 1985-1989 19
Table 32: Japan's Imports by Major Supplier, 1985-1989 20
Table 33: Japan's Trade Balance with Major Trading Partners, 1985-1989 21
Table 34: Japan's Exports by Commodity, 1985-1989 22
Table 35: Japan's Imports by Commodity, 1985-1989 25
Table 36: Japan's Dollar-Based Trade with the United States, 1985-1989 28
Table 37: Japan's Yen-Based Trade with the United States, 1985-1989 28
Table 38: Japan's Foreign Direct Investment by Country, FY 1985-FY 1989 29
Table 39: Japan's Foreign Direct Investment by Industry, FY 1985-FY 1989 29
Table 40: U.S. International Transactions, 1985-1989 30
Table 41: U.S. Transactions with Japan, 1985-1989 31
Table 42: U.S. Exports and Imports, 1985-1989 32
Table 43: U.S. Exports by Major Market, 1985-1989 33
Table 44: U.S. Imports by Major Supplier, 1985-1989 34
Table 45: U.S. Trade Balance with Major Trading Partners, 1985-1989 35
Table 46: U.S. Exports by End-Use Category, 1988-1989 36
Table 47: U.S. Imports by End-Use Category, 1988-1989 38
Table 48: U.S. Trade with Japan, 1985-1989 40
Table 49: U.S. Exports to Japan by End-Use Category, 1988-1989 41
Table 50: U.S. Imports from Japan by End-Use Category, 1988-1989 44
Table 51: U.S. Direct Investment Position Abroad, Yearend 1985-1989 46
Table 52: U.S. Direct Investment Position in Japan, Yearend 1985-1989 46
Table 53: Foreign Direct Investment Position in the United States, Yearend 1985-1989 47
Table 54: Japan's Foreign Direct Investment Position in the United States, Yearend 1985-1989 47

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Table 1: Japan's Gross National Product at 1980 Constant Prices, 1985-1989

(in billions of yen, seasonally adjusted, quarterly figures at annual rates)

	1985	1986	1987	1988	1989
Gross National Product	Y291,806.9	Y299,023.9	Y312,903.2	Y330,886.9	Y347,153.1
	(4.9%)	(2.5%)	(4.6%)	(5.7%)	(4.9%)
Personal Consumption Spending	162,326.4	167,288.1	174,400.0	183,376.1	189,809.4
	(2.7%)	(3.1%)	(4.3%)	(5.1%)	(3.5%)
Private Residential Construction	13,981.9	15,139.9	18,524.8	20,725.8	21,312.0
	(2.5%)	(8.3%)	(22.4%)	(11.9%)	(2.8%)
Private Fixed Nonresidential Investment	52,408.2	55,466.6	60,040.8	69,343.5	81,713.1
	(12.7%)	(5.8%)	(8.2%)	(15.5%)	(17.8%)
Change in Business Inventories	2,365.4	1,452.9	1,307.7	2,314.3	1,934.6
	(68.7%)	(-38.6%)	(-10.0%)	(77.0%)	(-16.4%)
Government Current Expenditures	27,011.8	28,682.3	28,524.1	29,151.7	29,759.5
	(1.7%)	(6.2%)	(-0.6%)	(2.2%)	(2.1%)
Government Fixed Investment	20,960.1	21,851.5	23,521.1	24,840.9	24,498.7
	(-6.4%)	(4.3%)	(7.6%)	(5.6%)	(-1.4%)
Change in Government Inventories	302.2	797.9	23.9	-181.6	-62.5
	(*)	(*)	(*)	(*)	(*)
Net External Sector	12,451.0	8,344.8	6,560.7	1,316.2	-1,811.7
	(31.4%)	(-33.0%)	(-21.4%)	(-79.9%)	(*)
Exports of Goods and Services and Factor Income Received	55,297.5	52,401.7	54,447.5	59,118.6	68,298.8
	(5.6%)	(-5.2%)	(3.9%)	(8.6%)	(15.5%)
Imports of Goods and Services and Factor Income Paid	42,846.5	44,056.9	47,886.8	57,802.4	70,110.5
	(-0.1%)	(2.8%)	(8.7%)	(20.7%)	(21.3%)

(continued)

Table 1: Japan's Gross National Product at 1980 Constant Prices, 1985-1989 (continued)

(in billions of yen, seasonally adjusted, quarterly figures at annual rates)

	January-March 1988	April-June 1988	July-September 1988	October-December 1988	January-March 1989	April-June 1989	July-September 1989	October-December 1989
Gross National Product	Y326,780.1 (7.5%)	Y325,794.2 (-1.2%)	Y333,343.0 (9.6%)	Y337,203.3 (4.7%)	Y343,155.4 (7.3%)	Y340,561.8 (-3.0%)	Y350,436.0 (12.1%)	Y353,352.3 (3.4%)
Personal Consumption Spending	180,476.2 (7.1%)	182,274.7 (4.1%)	184,559.6 (5.1%)	185,932.0 (3.0%)	188,458.9 (5.6%)	186,600.8 (-3.9%)	190,316.3 (8.2%)	193,336.8 (6.5%)
Private Residential Construction	21,503.5 (13.9%)	19,632.4 (-30.5%)	20,642.1 (22.2%)	21,241.7 (12.1%)	21,341.2 (1.9%)	20,855.0 (-8.8%)	21,328.5 (9.4%)	21,744.6 (8.0%)
Private Fixed Nonresidential Investment	65,005.1 (15.3%)	68,050.9 (20.1%)	70,888.6 (17.8%)	73,117.5 (13.2%)	77,820.6 (28.3%)	78,320.0 (2.6%)	83,374.1 (28.4%)	86,710.4 (17.0%)
Change in Business Inventories	1,898.2 (*)	2,361.2 (*)	2,571.7 (*)	2,362.2 (*)	1,080.4 (*)	2,463.2 (*)	2,077.4 (*)	2,117.2 (*)
Government Current Expenditures	28,903.2 (3.8%)	29,030.9 (1.8%)	29,223.2 (2.7%)	29,461.4 (3.3%)	29,647.9 (2.6%)	29,650.4 (0.0%)	29,732.0 (1.1%)	30,013.5 (3.8%)
Government Fixed Investment	25,530.8 (14.9%)	24,783.3 (-11.2%)	24,508.0 (-4.4%)	24,542.9 (0.6%)	24,674.3 (2.2%)	24,540.4 (-2.1%)	24,205.1 (-5.3%)	24,509.2 (5.1%)
Change in Government Inventories	293.9 (*)	66.8 (*)	-200.5 (*)	-879.0 (*)	261.2 (*)	371.8 (*)	63.4 (*)	-949.1 (*)
Net External Sector	3,169.3 (*)	-405.9 (*)	1,150.3 (*)	1,424.7 (*)	-129.0 (*)	-2,239.8 (*)	-660.8 (*)	-4,130.3 (*)
Exports of Goods and Services and Factor Income Received	56,921.5 (5.6%)	55,969.7 (-6.5%)	61,491.2 (45.7%)	62,093.4 (4.0%)	66,337.7 (30.3%)	65,824.7 (-3.1%)	70,171.1 (29.1%)	71,054.2 (5.1%)
Imports of Goods and Services and Factor Income Paid	53,752.2 (19.3%)	56,375.6 (21.0%)	60,340.8 (31.2%)	60,668.7 (2.2%)	66,466.7 (44.1%)	68,064.5 (10.0%)	70,831.9 (17.3%)	75,184.5 (26.9%)

*Cannot be calculated or meaningless.

Source: Economic Planning Agency

Table 2: Major Interest Rates in Japan, 1985-1989

(percent per annum)

	Central Bank Discount Rate*	Long-Term Prime Lending Rate*	Call Rate**	Average Interest Rate on Loans and Discounts of All Banks*	Savings Deposits* Commercial Banks		Savings Deposits* Post Office		Average Interest Rate on Certificates of Deposit*
					Ordinary Deposits	Six-Month Time Deposits	Ordinary Deposits	One-Year Savings Certificates	
1985	5.0%	7.2%	6.46%	6.47%	1.50%	4.75%	2.88%	4.0%	7.73%
1986	3.0	6.2	4.79	5.51	0.26	3.01	1.68	2.26	4.56
1987	2.5	5.7	3.51	4.94	0.26	2.64	1.68	2.26	4.53
1988	2.5	5.7	3.62	4.93	0.26	2.64	1.68	2.26	4.48
1989	4.25	6.5	4.87	5.78	0.50	3.57	1.92	2.82	6.65

*End of period.
**Average for period.

Source: Bank of Japan

Table 3: Money Supply in Japan, 1985-1989

(in billions of yen, average for period)

	Outstanding Money Supply (M_2+CDs)*	Change
1985	Y295,183	8.4%
1986	320,732	8.7
1987	354,036	10.4
1988	393,667	11.2
1989	432,671	9.9

*Includes currency in circulation, demand deposits and time deposits (excluding trust accounts) held by commercial banks, plus certificates of deposit.

Source: Bank of Japan

Table 4: Japan's General Account Expenditures (Revised), FY 1985-FY 1989*

(in billions of yen and percent change)

	FY 1985		FY 1986		FY 1987		FY 1988		FY 1989	
Total Expenditures	Y53,222.9	3.3%	Y53,824.8	1.1%	Y58,214.2	8.2%	Y61,851.7	6.3%	Y66,311.9	7.2%
Social Security	9,830.8	1.5	10,090.3	2.6	10,321.8	2.3	11,801.4	14.3	12,474.2	5.7
Public Assistance	1,082.2	-8.9	1,110.4	2.6	1,105.2	-0.5	1,062.0	-3.9	1,080.6	1.8
Social Welfare	2,056.2	2.1	1,977.8	-3.8	2,033.2	2.8	2,146.3	5.6	2,309.7	7.6
Social Insurance	5,847.5	4.1	6,137.3	5.0	6,310.2	2.8	7,732.3	22.5	8,203.4	6.1
Health Services	464.4	-4.4	497.2	7.1	512.3	3.0	500.7	-2.3	526.4	5.3
Unemployment Compensation	380.5	0.6	367.6	-3.4	361.0	-1.8	360.2	-1.2	354.1	-1.7
Education and Science	4,904.3	-0.3	4,886.6	-0.4	5,063.7	3.6	4,982.0	-1.6	5,075.3	1.9
Compulsory Education	2,415.2	2.0	2,414.9	-0.0	2,392.9	-0.9	2,463.5	3.0	2,475.5	0.5
Transfer to School Account	1,075.1	-2.0	1,083.7	0.8	1,180.1	8.9	1,124.4	-4.7	1,184.8	5.4
Science and Technology Promotion	375.4	0.2	381.8	1.7	473.5	24.0	426.6	-9.9	453.9	6.4
School Facilities	385.5	-9.8	350.0	-9.2	354.6	1.3	283.3	-20.1	262.7	-7.3
School Aid	569.6	0.5	575.7	1.1	580.9	0.9	601.0	3.5	615.4	2.4
Student Loans	83.6	-3.0	80.5	-3.7	81.7	1.5	83.3	2.0	83.0	-0.4
Public Works	6,922.3	0.6	6,946.3	0.3	7,428.0	6.9	6,683.0	-10.0	7,398.9	10.7
Erosion and Flood Control	1,082.8	-1.4	1,101.4	1.7	1,221.9	10.9	1,059.4	-13.3	1,080.6	2.0
Road Improvement	1,856.1	-2.3	1,826.3	-1.6	1,983.8	8.6	1,744.1	-12.1	1,782.6	2.2
Harbors and Airports	511.9	-1.5	517.3	1.1	563.7	9.0	497.1	-12.8	511.5	2.9
Housing	927.9	1.5	940.2	1.3	964.4	2.6	930.3	-3.5	1,539.2	65.5
Social Infrastructure	970.3	-1.0	989.0	1.9	1,106.1	11.8	942.6	-14.8	954.9	1.3
Agricultural Infrastructure	879.0	-1.5	886.9	0.9	963.7	8.7	852.4	-11.5	867.8	1.8
Forestry and Industrial Water Supplies	169.6	-2.1	170.4	0.5	181.2	6.3	163.0	-10.0	169.1	3.7
Disaster Reconstruction	514.0	30.6	503.5	-2.0	431.6	-14.3	483.8	12.1	482.3	-0.3
Reserves	10.7	-2.2	11.3	5.6	11.8	3.6	10.4	-11.9	10.9	4.8
Pensions	1,863.7	-1.2	1,850.1	-0.7	1,895.6	2.5	1,879.8	-0.8	1,855.7	-1.3
Civil Servants	124.8	2.8	121.4	-2.7	122.2	0.7	118.1	-3.4	111.8	-5.3
Veterans	1,578.7	-1.4	1,562.6	-1.0	1,606.9	2.8	1,599.0	-0.5	1,588.5	-0.7
Other Pensions	149.9	2.7	155.9	4.0	157.6	1.1	154.4	-2.0	147.4	-4.5
Administrative Costs	10.4	-1.4	10.3	-0.1	8.9	-14.3	8.4	-5.6	8.0	-4.8
Local Allocation Tax	9,690.1	7.2	9,734.7	0.5	11,086.2	13.9	13,031.2	17.5	14,964.7	14.8
National Debt Service	10,180.5	10.3	10,664.4	4.8	11,851.4	11.1	12,030.7	1.5	12,089.8	0.5
Defense	3,169.7	7.0	3,338.0	5.3	3,507.8	5.1	3,728.3	6.3	3,969.9	6.5
Economic Cooperation	581.2	7.5	600.5	3.3	661.3	10.1	714.4	8.0	771.3	8.0
Small Business Assistance	211.9	-8.0	225.6	6.5	263.2	16.6	257.6	-2.1	240.5	-6.6
Energy Support	626.2	2.6	570.5	-8.9	496.8	-12.9	458.4	-7.7	546.1	19.1
Food Agency Account	695.2	-14.0	613.8	-11.7	688.2	12.1	480.4	-30.2	459.2	-4.4
Miscellaneous	4,346.9	-0.5	4,104.0	-5.6	4,292.2	4.6	4,304.6	0.3	4,966.4	15.4
Reserves	200.0	17.6	200.0	0.0	200.0	0.0	200.0	0.0	200.0	0.0
Industrial Investment Special Account	0.0	0.0	0.0	0.0	458.0	100.0	1,300.0	183.8	1,300.0	0.0

*Revised budget figures include the supplementary budget.

Source: Ministry of Finance

Table 5: Japan's Discretionary General Account Spending (Revised), FY 1985-FY 1989*

(in billions of yen and percent change)

	FY 1985		FY 1986		FY 1987		FY 1988		FY 1989	
Total Expenditures	Y53,222.9	3.3%	Y53,824.8	1.1%	Y58,214.2	8.2%	Y61,851.7	6.3%	Y66,311.9	7.2%
Minus										
Debt Service and Transfers to Local Governments	19,870.6	8.8	20,399.1	2.7	22,937.6	12.4	25,061.9	9.3	27,054.5	8.0
Equals										
Discretionary Spending	33,352.3	0.3	33,425.8	0.2	35,276.5	5.5	36,789.8	4.3	39,257.4	6.7

*Revised budget figures include the supplementary budget.

Source: Ministry of Finance

Table 6: Japan's General Account Revenues (Revised), FY 1985-FY 1989*

(in billions of yen and percent change)

	FY 1985		FY 1986		FY 1987		FY 1988		FY 1989	
Total Revenues	Y53,222.9	3.3%	Y53,824.8	1.1%	Y58,214.2	8.2%	Y61,851.7	6.3%	Y66,311.9	7.2%
Tax and Stamp Revenues	38,145.0	9.5	39,440.0	3.4	43,087.0	9.3	48,106.0	11.7	54,227.0	12.7
Direct Taxes	28,579.0	9.1	29,469.0	3.1	31,703.0	7.6	36,284.0	14.5	41,541.0	14.5
Income Taxes	15,378.0	10.0	16,393.0	6.6	16,188.0	-1.3	16,928.0	4.6	20,057.0	18.5
Corporate Taxes	12,197.0	7.6	11,725.0	-3.9	13,722.0	17.0	17,712.0	29.1	19,577.0	10.5
Inheritance and Gift Taxes	1,004.0	14.4	1,351.0	34.6	1,793.0	32.7	1,644.0	-8.3	1,907.0	16.0
Indirect Taxes and Stamp Revenues	9,566.0	10.7	9,971.0	4.2	11,384.0	14.2	11,822.0	3.9	12,686.0	7.3
Liquor Taxes	1,955.0	-1.9	1,974.0	1.0	2,042.0	3.4	2,066.0	1.2	1,801.0	-12.8
Gasoline Taxes	1,554.0	-3.9	1,572.0	1.2	1,596.0	1.5	1,314.0	-17.7	1,365.0	3.9
Consumption Tax	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	3,618.0	100.0
Commodity Taxes	1,538.0	2.3	1,627.0	5.8	1,686.0	3.6	1,864.0	10.6	0.0	-100.0
Securities Transaction Tax	603.0	19.1	981.0	62.7	1,766.0	80.0	1,800.0	1.9	1,234.0	-31.4
Stamp Revenues	1,366.0	2.4	1,462.0	7.0	1,806.0	23.5	1,973.0	9.2	1,849.0	-6.3
Monopoly Profits	6.6	-99.4	7.6	15.2	6.0	-21.1	8.0	34.2	7.7	-3.8
Public Enterprise Receipts	15.9	3.2	16.7	5.0	17.5	4.8	16.7	-5.0	16.9	1.7
Sale of Public Properties	157.9	71.1	134.5	-14.8	180.6	34.3	126.1	-30.2	173.3	37.5
Miscellaneous	2,254.0	-1.3	2,289.7	1.6	2,044.7	-10.7	2,653.5	29.8	2,385.4	-10.1
Public Bonds	12,438.0	-3.3	11,495.0	-7.6	10,539.0	-8.3	7,967.0	-24.4	7,111.0	-10.7
Carryover Surplus	205.4	-49.5	441.3	114.8	2,339.4	430.1	2,974.6	27.2	2,390.6	-19.6

*Revised budget figures include the supplementary budget.

Source: Ministry of Finance

Table 7: Uses and Sources of Japan's Fiscal Investment and Loan Program Outlays (Initial), FY 1985-FY 1989

(in billions of yen and percent change)

	FY 1985		FY 1986		FY 1987		FY 1988		FY 1989	
Total Outlays	Y20,858.0	-1.2%	Y22,155.1	6.2%	Y27,081.3	7.1%	Y29,614.0	9.4%	Y32,270.5	9.0%
Housing	5,289.3	-0.0	5,856.2	10.7	6,328.2	8.1	6,921.5	9.4	7,460.6	7.8
Other Social Infrastructure	3,280.9	9.1	3,694.5	12.6	3,998.7	8.2	4,450.9	11.3	4,371.3	-1.8
Welfare	595.7	-6.6	625.9	5.1	627.7	0.3	661.8	5.4	736.0	11.2
Education	745.3	-4.1	678.2	-9.0	784.1	15.6	637.6	-18.7	520.2	-18.4
Small Business	3,764.4	-5.1	3,700.0	-1.7	3,985.6	7.7	4,030.6	1.1	4,176.4	3.6
Agriculture	890.6	-13.9	902.1	1.3	907.8	0.6	979.4	7.9	924.4	-5.6
Land Conservation and Disaster Work	472.8	24.7	422.7	-10.6	493.0	16.6	409.8	-16.9	357.9	-12.7
Roads	1,826.4	6.7	2,024.4	10.8	2,363.0	16.7	2,512.1	6.3	2,576.8	2.6
Transportation and Communications	1,763.4	-6.6	2,015.1	14.3	2,264.1	12.4	2,229.9	-1.5	2,361.6	5.9
Regional Development	511.2	2.2	566.1	10.7	657.7	16.2	652.2	-0.8	676.6	3.7
Industry and Technology	603.3	-2.7	635.9	5.4	630.9	-0.8	687.2	8.9	758.7	10.4
Foreign Trade and Economic Cooperation	1,114.7	-13.8	1,034.0	-7.2	690.5	-33.2	1,171.0	69.6	1,420.0	21.3
Cash Management	n.a.	n.a.	n.a.	n.a.	3,350.0	n.a.	4,270.0	27.5	5,930.0	38.9
Total Revenues	Y25,858.0	4.7%	Y27,155.1	5.0%	Y31,081.3	14.5%	Y33,114.0	6.5%	Y34,570.5	4.4%
Industrial Investment Special Account	31.4	554.2	61.5	95.9	144.3	134.6	91.2	-36.8	85.2	-6.6
Trust Fund Bureau Fund	20,029.0	5.9	20,738.6	3.5	24,595.8	18.6	26,206.6	6.6	26,871.3	2.5
Postal Savings	6,400.0	-7.2	7,000.0	9.4	7,900.0	12.9	7,900.0	0.0	8,500.0	7.6
Pension Contributions	3,950.0	2.6	4,300.0	8.9	4,450.0	3.5	3,500.0	-21.3	4,310.0	23.1
Other Revenues	9,679.0	18.7	9,438.6	-2.5	12,245.8	29.7	14,806.6	20.9	14,061.3	-5.0
Postal Life Insurance Fund	2,587.6	0.0	3,145.0	21.5	3,941.2	25.3	4,409.4	11.9	5,614.0	27.3
Government-Guaranteed Bonds and Borrowings	3,210.0	0.0	3,210.0	0.0	2,400.0	-25.2	2,406.8	0.3	2,000.0	-16.9

Source: Ministry of Finance

Table 8: Japan's Industrial Production Index by Sector, 1985-1989

(1985 = 100)

	Total									
	Index	Change	Mining	Manufacturing	Steel	Nonferrous Metals	Fabricated Metal Products	Nonelectric Machinery	Electric Machinery	Transport Equipment
1985	100.0	3.7%	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
1986	99.8	-0.2	99.6	99.8	94.4	100.0	99.7	95.6	104.2	98.1
1987	103.2	3.4	90.3	103.2	96.3	107.6	103.2	95.9	113.7	96.8
1988	113.0	9.5	85.9	113.1	105.0	114.2	111.0	110.3	132.3	105.5
1989	119.9	6.1	81.8	120.1	106.9	122.1	116.1	122.2	142.1	116.2

	Precision Instruments	Nonmetallic Mineral Products	Chemicals	Petroleum and Coal Products	Plastic Products	Pulp, Paper and Paper Products	Textiles	Food and Tobacco Products	Other
1985	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
1986	104.5	96.8	103.2	96.4	101.8	103.0	95.9	101.1	100.7
1987	105.4	100.3	111.1	92.9	106.7	109.2	94.4	101.9	103.9
1988	114.1	109.6	120.4	96.7	113.3	118.7	94.5	103.6	109.8
1989	120.8	114.0	128.7	101.4	117.7	127.6	93.7	104.7	115.0

Source: Ministry of International Trade and Industry

Table 9: Japan's Index of Industrial Production by End-Use Classification, 1985-1989

(1985 = 100)

	Final Demand Goods					
				Consumer Goods		
	Total	Capital Goods	Construction Materials	Durable	Nondurable	Producer Goods
1985	100.0	100.0	100.0	100.0	100.0	100.0
1986	100.6	99.0	99.8	102.3	101.9	98.7
1987	103.2	102.2	105.5	101.5	104.5	103.1
1988	112.2	116.6	112.0	108.8	109.4	113.9
1989	119.1	128.7	116.5	112.4	113.6	120.9

Source: Ministry of International Trade and Industry

Table 10: Japan's Index of Producers' Inventories of Finished Goods, 1985-1989

(1985 = 100)

	Total	Mining	Manufacturing	Steel	Nonferrous Metals	Fabricated Metal Products	Nonelectric Machinery	Electric Machinery	Transport Equipment
1985	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
1986	101.1	163.0	100.9	96.2	101.0	98.4	104.3	103.6	93.8
1987	97.4	264.3	96.9	89.4	93.6	100.6	95.4	98.8	92.4
1988	99.0	276.4	98.4	91.6	89.7	103.9	94.4	104.1	90.4
1989	106.8	261.2	106.3	92.3	98.8	110.2	104.1	128.3	98.2

	Precision Instruments	Nonmetallic Mineral Products	Chemicals	Petroleum and Coal Products	Plastic Products	Pulp, Paper and Paper Products	Textiles	Food and Tobacco Products	Other
1985	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
1986	118.8	104.4	102.3	99.4	100.5	104.6	103.3	99.4	99.1
1987	112.8	98.7	98.2	98.5	99.8	107.2	97.0	95.5	95.9
1988	101.5	96.4	102.3	99.7	104.8	106.4	98.7	93.2	103.7
1989	113.8	99.9	112.8	104.3	112.2	122.8	103.8	86.1	113.1

Source: Ministry of International Trade and Industry

Table 11: Japan's Index of Consumption of Materials, 1985-1989

(1985 = 100)

	Manufacturing	Steel	Non-ferrous Metals	Fabricated Metal Products	Machinery	Nonmetallic Mineral Products	Chemicals	Petroleum and Coal Products	Plastic Products	Pulp, Paper and Paper Products	Textiles	Other Industries
1985	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
1986	96.1	89.7	100.2	99.3	94.9	99.1	99.5	95.7	102.1	101.7	94.3	97.6
1987	97.6	90.4	104.7	104.9	95.2	102.9	105.7	93.1	108.3	106.9	94.0	101.1
1988	105.4	98.9	111.5	110.2	105.5	111.3	113.7	96.5	116.1	115.0	93.6	104.0
1989	110.6	102.0	115.1	114.6	111.8	115.5	120.9	101.4	121.3	122.7	93.1	106.1

Source: Ministry of International Trade and Industry

Table 12: Japan's Index of Inventories of Materials, 1985-1989

(1985 = 100)

	Manufacturing	Steel	Non-ferrous Metals	Fabricated Metal Products	Machinery	Nonmetallic Mineral Products	Chemicals	Petroleum and Coal Products	Plastic Products	Pulp, Paper and Paper Products	Textiles	Other Industries
1985	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
1986	95.1	98.2	77.7	92.2	89.1	94.9	99.6	99.6	89.7	94.8	93.4	99.6
1987	91.4	91.8	64.3	88.0	82.6	90.8	100.0	97.0	99.7	90.7	91.6	100.5
1988	94.7	97.3	65.0	91.6	91.1	92.8	100.4	97.9	102.9	96.1	95.9	100.1
1989	95.0	97.8	63.4	93.6	97.2	100.1	105.0	88.6	104.2	102.8	97.1	102.1

Source: Ministry of International Trade and Industry

Table 13: Japan's Index of Manufacturing Operating Rates, 1985-1989

(1985 = 100)

	Total	Steel	Non-ferrous Metals	Fabricated Metal Products	Nonelectric Machinery	Electric Machinery	Transport Equipment	Precision Instruments	Nonmetallic Mineral Products	Chemicals	Petroleum and Coal Products	Pulp, Paper and Paper Products	Textiles
1985	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
1986	95.4	93.9	98.8	98.5	87.7	92.4	95.9	95.2	96.7	99.9	95.9	102.8	99.1
1987	95.5	95.6	104.8	103.4	83.1	90.1	95.0	88.8	95.4	104.3	97.4	109.6	98.2
1988	101.1	105.9	109.1	112.5	96.3	91.6	98.6	93.3	101.6	109.5	104.1	118.6	99.8
1989	103.3	110.4	111.6	119.5	100.1	88.6	102.2	83.7	106.0	111.0	110.6	124.3	100.0

Source: Ministry of International Trade and Industry

Table 14: Residential Construction Starts in Japan, 1985-1989

(units)

		Type of Housing		Owner-Occupant Relationship			
	Total	Public	Private	Owner-Built	Developer-Built	Rental Units	Other
1985	1,236,072	81,305	1,154,767	464,697	224,018	527,042	20,315
1986	1,364,609	80,780	1,283,829	477,050	220,155	645,886	21,518
1987	1,674,300	80,719	1,593,581	546,316	246,861	858,726	22,397
1988	1,684,644	84,466	1,600,178	508,660	293,311	858,665	24,008
1989	1,662,612	78,674	1,583,938	504,228	312,005	817,186	29,193

Source: Ministry of Construction

Table 15: Japan's Labor Force Survey, 1985-1989

(in thousands of persons)

	Working-Age Population*	Total Labor Force	Employed Labor Force	Totally Unemployed Labor Force	Unemployment Rate	Not in Labor Force	Ratio of Job Openings to Applications**
1985	94,650	59,630	58,070	1,560	2.6%	34,500	0.68
1986	95,870	60,200	58,530	1,670	2.8	35,130	0.62
1987	97,200	60,840	59,110	1,730	2.8	35,840	0.70
1988	98,490	61,660	60,110	1,550	2.5	36,350	1.01
1989	99,740	62,700	61,280	1,420	2.3	36,550	1.26

*People 15 years old and over.
**Excludes applications by new school graduates but includes those by people seeking part-time work.

Source: Prime Minister's Office and Ministry of Labor

Table 16: Employment Index of Regular Workers in Japan, 1985-1989

(1985 = 100)

	Total	Mining	Construction	Manufacturing	Foods and Tobacco	Textiles	Apparel	Lumber and Wood Products	Pulp and Paper Products	Publishing	Chemicals	Petroleum and Coal Products	Nonmetallic Mineral Products	Steel
1985	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
1986	101.4	93.4	99.5	101.2	102.9	96.6	103.6	99.9	101.7	101.6	101.4	97.3	99.5	97.2
1987	102.0	87.3	101.9	99.7	104.5	94.6	103.0	103.2	101.8	103.3	102.4	92.0	98.9	91.8
1988	103.5	81.4	104.2	100.3	106.3	93.1	103.8	103.8	101.7	107.3	103.0	87.6	98.4	88.2
1989	106.2	75.0	106.7	102.1	108.1	92.0	106.5	101.5	101.8	110.8	103.2	85.2	98.9	88.0

	Nonferrous Metals	Fabricated Metal Products	Nonelectric Machinery	Electric Machinery	Transport Equipment	Precision Instruments	Utilities	Transportation and Communications	Wholesale and Retail Trade	Finance and Insurance	Real Estate	Services
1985	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
1986	99.6	101.0	102.4	103.1	99.5	99.5	100.6	98.8	102.4	100.4	102.2	103.2
1987	98.9	101.4	100.2	100.7	94.9	95.3	101.0	96.0	105.9	103.5	106.8	105.9
1988	98.5	104.0	100.5	102.1	94.6	94.3	100.5	95.8	108.6	104.5	111.7	109.1
1989	100.2	107.5	103.1	104.1	97.8	95.9	99.5	97.2	112.1	106.5	119.0	113.4

Source: Ministry of Labor

Table 17: Nominal Wage Index of Regular Workers in Japan, 1985-1989

(1985 = 100)

	Total	Mining	Construction	Manufacturing	Foods and Tobacco	Textiles	Apparel	Lumber and Wood Products	Pulp and Paper Products	Publishing	Chemicals	Petroleum and Coal Products	Nonmetallic Mineral Products	Steel
1985	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
1986	102.7	99.1	104.3	101.5	105.2	102.1	100.8	104.9	101.7	104.7	102.6	103.3	103.3	100.1
1987	104.7	100.3	107.1	103.2	106.8	105.6	103.2	109.0	103.8	105.0	106.2	106.5	105.7	98.4
1988	108.7	102.2	112.8	107.8	107.6	108.4	107.1	112.7	106.5	104.0	110.5	113.2	112.5	103.7
1989	113.8	106.6	120.9	114.0	112.4	114.1	113.3	117.6	113.7	106.4	116.2	119.6	116.7	112.5

	Nonferrous Metals	Fabricated Metal Products	Nonelectric Machinery	Electric Machinery	Transport Equipment	Precision Instruments	Utilities	Transportation and Communications	Wholesale and Retail Trade	Finance and Insurance	Real Estate	Services
1985	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
1986	102.7	103.5	99.4	100.4	100.7	100.4	105.2	102.1	102.7	105.1	105.7	103.7
1987	105.4	104.4	100.6	103.7	101.0	101.2	107.5	105.9	104.2	108.0	109.1	104.8
1988	110.4	109.0	107.1	108.5	108.5	108.4	111.4	111.4	107.4	111.9	113.0	107.3
1989	115.2	116.6	112.3	115.8	114.0	113.7	116.4	116.7	112.5	114.6	125.4	110.9

Source: Ministry of Labor

Table 18: Average Monthly Wages of Manufacturing Employees in Japan by Industry, 1985-1989

(in thousands of yen)

	Total	Foods and Tobacco	Textiles	Pulp and Paper Products	Chemicals	Nonmetallic Mineral Products	Steel	Nonferrous Metals	Fabricated Metal Products	Nonelectric Machinery	Electric Machinery	Transport Equipment	Precision Instruments
1985	Y299.5	Y235.5	Y211.9	Y314.6	Y389.6	Y289.0	Y391.7	Y336.4	Y287.8	Y337.6	Y280.7	Y345.1	Y287.4
1986	305.4	250.6	216.9	322.0	402.8	299.2	392.1	345.1	298.5	334.9	283.6	348.3	288.9
1987	313.2	259.6	224.2	331.7	419.2	308.1	385.2	354.6	302.6	340.7	296.2	352.4	292.2
1988	318.7	245.4	227.3	329.5	421.5	325.9	403.9	373.6	312.6	362.7	299.1	369.6	310.5
1989	336.6	256.7	239.2	351.1	443.6	338.1	438.3	389.7	333.6	380.6	318.9	388.7	325.7

Note: Includes overtime pay and bonuses.

Source: Ministry of Labor

Table 19: Index of Labor Productivity in Japan, 1985-1989

(1985 = 100)

	Total	Mining	Manufacturing	Foods	Textiles	Lumber and Wood Products	Pulp and Paper Products	Nonmetallic Mineral Products	Rubber Products	Chemicals
1985	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
1986	101.9	108.4	101.8	101.4	100.8	112.9	105.7	99.8	99.7	104.2
1987	107.8	123.8	107.7	100.4	102.5	107.3	113.3	105.6	104.9	113.2
1988	120.2	137.0	120.1	104.6	107.8	112.9	123.5	125.5	112.0	122.2
1989	127.7	141.0	127.6	108.0	109.8	108.7	133.5	133.0	118.3	132.3

	Plastic Products	Petroleum and Coal Products	Steel	Nonferrous Metals	Fabricated Metal Products	Nonelectric Machinery	Electric Machinery	Transport Equipment	Precision Instruments
1985	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
1986	100.2	103.5	97.9	101.2	102.1	97.3	102.9	101.0	109.1
1987	105.6	107.4	107.1	109.1	108.4	102.8	114.5	102.9	118.1
1988	111.9	119.6	121.5	114.6	116.5	119.3	134.5	113.0	138.7
1989	115.0	131.5	128.3	122.3	119.4	132.9	144.7	120.4	148.1

Source: Japan Productivity Center

Table 20: Japan's Consumer Price Index, 1985-1989

(1985 = 100)

	Total		Food	Housing	Utilities	Furniture and Housewares	Clothing	Medical Care	Transportation	Education	Recreation	Miscellaneous
	Index	Change										
1985	100.0	2.0%	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
1986	100.6	0.6	100.2	102.5	95.0	100.0	102.2	101.9	99.3	103.6	101.5	102.0
1987	100.7	0.1	99.3	105.4	88.0	99.4	103.3	103.8	100.0	107.1	102.0	103.2
1988	101.4	0.7	100.0	107.6	85.9	98.9	104.5	104.2	99.5	110.7	102.6	103.6
1989	103.7	2.3	102.2	110.8	85.6	99.4	109.1	105.8	100.6	115.1	105.9	105.1

Source: Management and Coordination Agency

Table 21: Japan's Wholesale Price Index by Industry, 1985-1989

(1985 = 100)

	Total											
	Index	Change	Foods	Textiles	Lumber and Wood Products	Pulp, Paper and Paper Products	Chemicals	Plastic Products	Petroleum and Products	Nonmetallic Mineral Products	Steel	Nonferrous Metals
1985	100.0	-1.1%	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
1986	90.9	-9.1	99.4	91.8	95.2	96.3	89.4	95.6	76.9	98.1	90.1	83.2
1987	87.5	-3.7	98.5	90.5	105.0	94.5	85.7	92.1	64.3	96.5	86.9	83.1
1988	86.6	-1.0	97.9	90.3	103.2	95.3	86.1	92.2	60.8	95.8	90.7	90.6
1989	88.8	2.5	99.1	93.0	111.1	98.3	88.0	94.3	63.9	97.9	95.2	96.7

	Metal Products	Nonelectric Machinery	Electric Machinery	Transport Equipment	Precision Instruments	Miscellaneous Manufactures	Agricultural, Forestry and Fishery Products	Mining Products	Utilities
1985	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
1986	98.4	96.3	89.8	94.8	98.2	97.3	91.0	56.4	95.3
1987	95.6	93.8	84.3	92.6	97.4	95.3	86.7	50.8	89.0
1988	97.7	93.4	80.4	90.8	94.4	95.8	87.2	45.6	84.0
1989	101.5	96.4	79.7	91.9	93.1	99.7	89.8	50.2	81.1

Source: Bank of Japan

Table 22: Japan's Wholesale Price Index by End-Use Classification, 1985-1989

(1985 = 100)

	Domestic Products										Exports			
			Intermediate Goods				Final Goods							
								Consumer Goods						
	Total	Raw Materials	Total	Semi-finished Goods	Con-struction Materials	Fuels and Energy	Capital Goods	Total	Durables	Nondurables	Total	Semi-finished Goods	Capital Goods	Consumer Goods
1985	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
1986	91.8	66.5	92.0	91.3	97.5	85.6	97.7	98.0	97.4	98.1	84.9	80.0	89.2	87.0
1987	88.5	62.4	88.2	87.7	98.7	74.7	95.5	95.7	94.5	96.2	80.6	75.7	85.2	82.7
1988	87.8	59.9	88.2	88.5	100.4	69.9	95.2	93.9	90.9	95.0	78.8	75.9	83.2	78.3
1989	89.8	64.4	90.7	91.2	104.9	69.6	97.6	93.9	86.2	96.8	82.3	81.0	86.6	80.5

Source: Bank of Japan

Table 23: Japan's Global Balance of Payments, 1985-1989

(in millions of dollars, IMF value basis, seasonally unadjusted)

		Trade Balance	Exports	Imports	Services	Transfers	Current Account Balance	Long-Term Capital	Basic Balance	Short-Term Capital	Errors and Omissions	Overall Balance	Gold and Foreign Exchange Reserves*
1985		$55,986	$174,015	$118,029	$-5,165	$-1,652	$49,169	$-64,542	$-15,373	$-936	$3,991	$-12,318	$26,510
1986		92,827	205,591	112,764	-4,932	-2,050	85,845	-131,461	-45,616	-1,609	2,458	-44,767	42,239
1987		96,386	224,605	128,219	-5,702	-3,669	87,015	-136,532	-49,517	23,865	-3,893	-29,545	81,479
1988		95,012	259,765	164,753	-11,263	-4,118	79,631	-130,930	-51,299	19,521	2,796	-28,982	97,662
1989		76,917	269,570	192,653	-15,526	-4,234	57,157	-89,246	-32,089	20,811	-22,008	-33,286	84,895
1988	January	4,557	17,038	12,481	-939	-113	3,505	-3,642	-137	2,764	3,062	5,689	83,407
	February	7,159	19,900	12,741	-322	-250	6,587	-8,296	-1,709	-1,294	1,241	-1,762	83,821
	March	9,305	22,407	13,102	-76	-900	8,329	-3,204	5,125	-3,441	3,083	4,767	84,857
	April	8,481	22,013	13,532	-1,019	-584	6,878	-10,213	-3,335	1,683	-1,873	-3,525	86,838
	May	6,582	20,120	13,538	-813	-201	5,568	-16,247	-10,679	2,525	840	-7,314	87,244
	June	7,385	21,426	14,041	-1,050	-214	6,121	-10,096	-3,975	-3,479	-1,410	-8,864	87,700
	July	8,684	22,811	14,127	-1,584	-602	6,498	-18,377	-11,879	-1,953	-2,005	-15,837	88,908
	August	6,306	20,464	14,158	-1,113	-220	4,973	-12,846	-7,873	4,723	-2,421	-5,571	90,222
	September	8,775	22,714	13,939	-926	-268	7,581	-10,991	-3,410	7,312	-744	3,158	91,151
	October	9,091	22,961	13,870	-1,401	-237	7,453	-12,737	-5,284	4,849	738	303	92,496
	November	7,659	22,241	14,582	-621	-237	6,801	-10,289	-3,488	2,052	1,914	478	97,147
	December	11,028	25,670	14,642	-1,399	-292	9,337	-13,992	-4,655	3,780	371	-504	97,662
1989	January	4,887	19,033	14,146	-2,196	-186	2,505	-4,580	-2,075	2,447	2,387	2,759	98,177
	February	8,521	22,017	13,496	-994	-272	7,255	-3,511	3,744	4,295	-2,849	5,190	98,830
	March	7,903	25,895	17,992	-405	-1,194	6,304	2,479	8,783	2,892	4,330	16,005	99,353
	April	8,098	22,804	14,706	-1,288	-229	6,581	-16,368	-9,787	-4,821	-8,624	-23,232	100,361
	May	5,162	21,387	16,225	-1,531	-192	3,439	-12,511	-9,072	-3,173	-211	-12,456	95,694
	June	6,534	22,369	15,835	-2,073	-198	4,263	-1,922	2,341	6,851	-384	8,808	89,462
	July	7,028	23,027	15,999	-1,348	-182	5,498	-7,188	-1,690	-2,329	-6,820	-10,839	88,865
	August	4,872	21,447	16,575	-1,153	-289	3,430	-3,626	-196	2,416	-793	1,427	88,318
	September	7,870	23,683	15,813	-1,522	-319	6,029	-10,745	-4,716	16,986	-3,931	8,339	86,117
	October	5,485	22,437	16,952	-1,446	-306	3,733	-25,677	-21,944	-14,734	-188	-36,866	84,293
	November	4,133	21,410	17,277	261	-287	4,107	-8,821	-4,714	4,907	38	231	84,747
	December	6,424	24,061	17,637	-1,831	-580	4,013	3,224	7,237	5,074	-4,963	7,348	84,895

*End of period.

Note: For capital transactions, credits (+) indicate net inflows and debits (-) indicate net outflows.

Source: Bank of Japan and Ministry of Finance

Table 24: Japan's Balance of Payments with the United States, 1985-1989

(in millions of dollars, IMF value basis)

	1985	1986	1987	1988	1989
Merchandise Trade Balance	$42,988	$54,919	$57,117	$52,448	$49,404
Exports	65,617	80,385	83,010	89,146	92,741
Imports	22,629	25,466	25,893	36,698	43,337
Services Balance	-1,012	-585	1,021	115	-1,198
Transportation	110	243	-698	-1,132	-1,610
Travel	-1,329	-2,012	-3,106	-5,721	-7,554
Investment Income	2,268	3,231	7,300	11,364	14,318
Other	-2,061	-2,047	-2,475	-4,396	-6,352
Official	1,495	1,931	1,751	1,578	1,307
Private	-3,556	-3,978	-4,226	-5,974	-7,659
Unilateral Transfers Balance	-249	-552	-1,460	-1,243	-723
Official	-27	-92	-779	-588	-613
Private	-222	-460	-681	-655	-110
Current Account Balance	41,727	53,782	56,678	51,320	47,483
Long-Term Capital (net)	-33,163	-65,650	-61,030	-59,260	-53,861
Direct Investments (net)	-2,043	-7,774	-9,018	-19,568	-22,768
Trade Credits (net)	-587	-334	-489	-1,024	-1,255
Loans (net)	-716	-690	-1,663	-2,830	-4,761
Stocks and Bonds (net)	-29,874	-55,944	-48,223	-33,320	-22,074
Other (net)	57	-908	-1,637	-2,518	-3,003
Basic Balance	8,564	-11,868	-4,352	-7,940	-6,378

Note: For long-term capital transactions, credits (+) indicate net inflows and debits (-) indicate net outflows.

Source: Bank of Japan

Table 25: Japan's Exports and Imports in Dollar Terms, 1985-1989

(in millions of dollars, customs clearance basis, seasonally unadjusted)

		Exports (f.o.b.)	Change Over Year-Earlier Period	Imports (c.i.f.)	Change Over Year-Earlier Period	Trade Balance
1985		$175,638	3.3%	$129,539	-5.1%	$46,099
1986		209,151	19.1	126,408	-2.4	82,743
1987		229,221	9.6	149,515	18.3	79,706
1988		264,917	15.6	187,354	25.3	77,563
1989		275,175	3.9	210,847	12.5	64,328
1988	January	17,329	16.2	14,254	34.5	3,075
	February	20,233	17.4	14,993	48.3	5,240
	March	22,717	17.6	15,258	35.5	7,459
	April	22,479	15.3	15,696	31.2	6,784
	May	20,648	10.9	15,461	26.8	5,187
	June	22,051	17.2	16,103	31.8	5,948
	July	23,147	16.3	15,966	23.2	7,180
	August	20,849	18.4	15,876	27.4	4,973
	September	23,174	13.8	15,416	19.2	7,758
	October	23,436	13.4	15,756	13.6	7,681
	November	22,681	19.8	16,117	13.6	6,563
	December	26,174	12.0	16,458	11.5	9,716
1989	January	19,359	11.7	16,113	13.0	3,246
	February	22,379	10.6	15,149	1.0	7,230
	March	26,489	16.6	19,881	30.3	6,608
	April	23,218	3.3	15,930	1.5	7,288
	May	21,702	5.1	17,946	16.1	3,756
	June	22,683	2.9	17,416	8.2	5,266
	July	23,456	1.3	17,461	9.4	5,995
	August	21,825	4.7	18,458	16.3	3,367
	September	24,314	4.9	17,129	11.1	7,186
	October	23,019	-1.8	18,368	16.6	4,651
	November	22,078	-2.7	18,550	15.1	3,528
	December	24,655	-5.8	18,446	12.1	6,208

Source: Ministry of Finance

Table 26: Japan's Exports and Imports in Yen Terms, 1985-1989

(in billions of yen, customs clearance basis, seasonally unadjusted)

		Exports (f.o.b.)	Change Over Year-Earlier Period	Imports (c.i.f.)	Change Over Year-Earlier Period	Trade Balance
1985		Y41,956	4.0%	Y31,085	-3.8%	Y10,871
1986		35,290	-15.9	21,551	-30.7	13,739
1987		33,315	-5.6	21,737	0.9	11,578
1988		33,939	1.9	24,006	10.4	9,933
1989		37,823	11.4	28,979	20.7	8,844
1988	January	2,188	-7.4	1,796	6.6	392
	February	2,603	-1.2	1,928	24.8	675
	March	2,923	-1.4	1,964	13.6	959
	April	2,826	-1.3	1,972	12.2	854
	May	2,576	-1.1	1,929	13.0	647
	June	2,762	2.9	2,017	15.8	745
	July	3,039	3.3	2,098	9.5	941
	August	2,776	4.5	2,113	12.5	662
	September	3,110	6.9	2,069	11.9	1,041
	October	3,095	3.7	2,089	4.2	1,006
	November	2,842	8.5	2,021	2.8	821
	December	3,202	3.6	2,011	2.7	1,191
1989	January	2,437	11.4	2,024	12.7	413
	February	2,876	10.5	1,947	1.0	929
	March	3,392	16.1	2,545	29.6	847
	April	3,068	8.6	2,105	6.7	963
	May	2,908	12.9	2,401	24.5	507
	June	3,247	17.6	2,492	23.6	755
	July	3,320	9.2	2,473	17.8	848
	August	3,061	10.3	2,590	22.5	472
	September	3,529	13.5	2,485	20.1	1,044
	October	3,286	6.2	2,619	25.4	668
	November	3,151	10.9	2,647	31.0	504
	December	3,548	10.8	2,653	31.9	895

Source: Ministry of Finance

Table 27: Japan's Export and Import Quantum (Volume) Indexes, 1985-1989

(1985 = 100)

		Exports		Imports	
		Index	Change Over Year-Earlier Period	Index	Change Over Year-Earlier Period
1985		100.0	n.a.	100.0	n.a.
1986		98.8	-1.2%	109.4	9.4%
1987		99.2	0.4	119.3	9.0
1988		103.6	4.4	139.1	16.7
1989		107.9	4.2	150.1	7.9
1988	January	82.1	-0.1	128.1	12.3
	February	96.6	4.2	135.8	31.3
	March	107.8	3.2	137.0	21.8
	April	105.0	3.1	141.1	20.5
	May	96.4	-0.6	136.3	17.7
	June	102.7	4.7	139.9	20.6
	July	109.8	5.6	142.0	15.7
	August	98.7	6.9	138.2	16.9
	September	111.1	7.0	136.5	13.3
	October	110.0	3.3	138.5	8.5
	November	104.1	10.4	146.0	12.5
	December	118.3	4.5	150.3	12.7
1989	January	87.3	6.3	144.8	13.0
	February	101.8	5.4	132.3	-2.6
	March	121.2	12.4	169.1	23.4
	April	107.0	1.9	134.9	-4.4
	May	100.6	4.4	150.4	10.3
	June	109.3	6.4	146.8	4.9
	July	111.4	1.5	146.1	2.9
	August	104.9	6.3	156.6	13.3
	September	118.9	7.0	146.4	7.3
	October	110.4	0.4	157.0	13.4
	November	104.5	0.4	158.1	8.3
	December	117.2	-0.9	158.9	5.7

Source: Ministry of Finance

Table 28: Japan's Export and Import Yen-Based Price Indexes, 1985-1989

(1985 = 100)

		Exports		Imports	
		Index	Change Over Year-Earlier Period	Index	Change Over Year-Earlier Period
1985		100.0	-1.5%	100.0	-2.4%
1986		84.9	-15.1	64.2	-35.8
1987		80.6	-5.1	58.9	-8.3
1988		78.8	-2.2	56.2	-4.6
1989		82.3	4.4	60.5	7.7
1988	January	77.4	-6.4	56.2	-3.3
	February	77.8	-5.2	56.3	-4.3
	March	77.7	-5.0	56.5	-4.2
	April	77.9	-2.3	55.6	-3.0
	May	77.7	-1.4	55.6	-2.8
	June	78.3	-2.5	56.8	-2.9
	July	80.2	-2.6	58.0	-4.3
	August	80.8	-1.2	57.7	-5.4
	September	81.1	0.6	57.8	-3.8
	October	79.8	-1.1	56.5	-6.8
	November	78.3	-1.0	53.9	-8.5
	December	78.2	0.9	53.7	-6.1
1989	January	79.2	2.3	55.4	-1.4
	February	79.4	2.1	56.7	0.7
	March	80.2	3.2	57.8	2.3
	April	80.6	3.5	59.4	6.8
	May	82.1	5.7	61.5	10.6
	June	84.2	7.5	62.9	10.7
	July	83.3	3.9	62.0	6.9
	August	83.0	2.7	61.8	7.1
	September	84.2	3.8	62.6	8.3
	October	83.3	4.4	61.7	9.2
	November	83.8	7.0	61.9	14.8
	December	83.8	7.2	61.9	15.3

Source: Bank of Japan

Table 29: Yen-Dollar Exchange Rate Used to Convert Customs Clearance Trade Data, 1985-1989*

		Exports	Imports
1985	Average	Y240.29	Y240.17
1986	Average	169.99	170.08
1987	Average	145.90	146.01
1988	Average	128.13	128.15
1989	Average	137.34	137.26
1988	January	126.24	126.01
	February	128.65	128.57
	March	128.65	128.72
	April	125.70	125.64
	May	124.75	124.76
	June	125.24	125.23
	July	131.31	131.40
	August	133.13	133.12
	September	134.18	134.21
	October	132.04	132.58
	November	125.30	125.36
	December	122.34	122.21
1989	January	125.88	125.64
	February	128.50	128.49
	March	128.06	128.00
	April	132.12	132.12
	May	133.98	133.78
	June	143.14	143.06
	July	141.54	141.60
	August	140.27	140.29
	September	145.15	145.10
	October	142.77	142.58
	November	142.72	142.67
	December	143.91	143.83

*Reflects the exchange rate that prevailed at the time export or import contracts were signed.

Source: Ministry of Finance

Table 30: Yen-Dollar Exchange Rate on Tokyo Foreign Exchange Market, 1985-1989

(average for period)

	1985	1986	1987	1988	1989
Average	Y238.54	Y168.52	Y144.64	Y128.15	Y137.96
January	254.18	200.07	154.48	127.56	127.23
February	260.24	184.64	153.48	129.16	127.77
March	258.63	178.93	151.54	127.28	130.36
April	251.67	175.62	142.98	124.93	132.08
May	251.54	166.83	140.54	124.77	138.35
June	248.99	167.95	144.48	127.14	143.79
July	241.75	158.60	150.21	133.07	140.72
August	237.21	154.00	147.56	133.63	141.11
September	236.95	154.72	143.00	134.44	145.05
October	214.73	155.95	143.54	129.02	141.93
November	203.72	162.64	135.25	123.19	143.52
December	202.82	162.29	128.59	123.63	143.66

Source: International Monetary Fund

Table 31: Japan's Exports by Major Market, 1985-1989

(in millions of dollars, f.o.b. value basis)

	1985	1986	1987	1988	1989
Total Exports	$175,638	$209,151	$229,221	$264,917	$275,175
Developed Countries	102,468	131,149	142,883	161,847	167,358
United States	65,278	80,456	83,580	89,634	93,189
Canada	4,520	5,526	5,611	6,424	6,807
Western Europe	25,199	37,483	45,555	56,023	56,494
Denmark	758	989	917	792	758
United Kingdom	4,723	6,647	8,400	10,632	10,741
Netherlands	2,071	3,261	4,071	5,054	5,112
Belgium	1,477	2,198	2,697	3,390	3,455
France	2,083	3,152	4,014	4,987	5,298
West Germany	6,938	10,477	12,833	15,793	15,920
Spain	605	1,076	1,343	1,860	1,942
Italy	1,117	1,723	2,103	2,787	2,783
European Community	20,016	30,675	37,693	46,873	47,908
Sweden	1,094	1,438	1,931	2,320	2,174
Switzerland	1,161	1,887	2,266	2,775	2,664
Austria	473	764	1,006	1,406	1,327
Australia	5,379	5,227	5,146	6,680	7,805
New Zealand	1,072	1,103	1,128	1,039	1,346
South Africa	1,020	1,355	1,863	2,047	1,717
Developing Countries	56,978	63,934	74,402	89,250	95,173
Latin America	8,486	9,495	8,760	9,297	9,381
Mexico	994	1,032	1,389	1,772	1,908
Panama	3,326	3,197	2,416	2,653	2,512
Chile	169	294	353	368	636
Brazil	615	973	879	998	1,310
Southeast Asia	33,248	41,788	52,982	67,109	73,516
South Korea	7,097	10,475	13,229	15,441	16,561
Taiwan	5,026	7,852	11,346	14,354	15,421
Hong Kong	6,509	7,161	8,872	11,706	11,526
Thailand	2,030	2,030	2,953	5,162	6,838
Singapore	3,861	4,577	6,008	8,311	9,239
Malaysia	2,168	1,708	2,168	3,060	4,124
Philippines	937	1,088	1,415	1,740	2,381
Indonesia	2,173	2,662	2,990	3,054	3,301
India	1,596	2,099	1,957	2,082	2,018
Middle East and North Africa	12,171	9,795	9,177	9,438	8,559
Iran	1,348	1,145	1,043	808	922
Saudi Arabia	3,890	2,762	3,239	3,142	2,763
Kuwait	1,536	1,220	857	731	671
Oman	554	288	262	348	334
United Arab Emirates	1,164	1,033	1,118	1,286	1,296
Subsaharan Africa	2,519	2,178	2,894	2,760	2,892
Communist Countries	16,190	14,064	11,924	13,818	12,644
China	12,478	9,856	8,250	9,476	8,516
U.S.S.R.	2,751	3,150	2,563	3,130	3,082

Source: Ministry of Finance

Table 32: Japan's Imports by Major Supplier, 1985-1989

(in millions of dollars, c.i.f. value basis)

	1985	1986	1987	1988	1989
Total Imports	$129,539	$126,408	$149,515	$187,354	$210,847
Developed Countries	53,121	62,233	71,610	94,785	107,313
United States	25,793	29,054	31,491	42,037	48,246
Canada	4,773	4,895	6,073	8,308	8,645
Western Europe	12,356	18,118	22,749	30,578	35,126
Denmark	579	781	944	1,142	1,199
United Kingdom	1,817	3,573	3,057	4,193	4,466
Netherlands	439	577	757	996	1,122
Belgium	482	677	859	1,125	1,430
France	1,324	1,855	2,871	4,315	5,546
West Germany	2,928	4,298	6,150	8,101	8,995
Spain	350	297	357	537	556
Italy	1,050	1,495	2,135	2,895	3,806
European Community	8,893	13,989	17,670	24,071	28,146
Sweden	441	575	682	977	1,086
Switzerland	1,758	2,571	3,101	3,565	3,863
Austria	180	247	349	442	521
Australia	7,452	6,980	7,869	10,285	11,605
New Zealand	903	956	1,168	1,644	1,657
South Africa	1,844	2,229	2,259	1,933	2,035
Developing Countries	67,936	55,941	67,277	78,704	87,946
Latin America	6,242	6,194	6,356	8,313	8,871
Mexico	1,870	1,439	1,625	1,591	1,730
Panama	81	84	69	137	85
Chile	534	535	617	1,023	1,322
Brazil	1,840	1,875	2,032	2,950	2,999
Southeast Asia	30,264	29,489	38,627	47,802	52,906
South Korea	4,092	5,292	8,076	11,811	12,994
Taiwan	3,386	4,691	7,128	8,744	8,979
Hong Kong	767	1,074	1,561	2,109	2,219
Thailand	1,027	1,391	1,796	2,751	3,583
Singapore	1,594	1,463	2,048	2,339	2,952
Malaysia	4,330	3,846	4,772	4,710	5,107
Philippines	1,243	1,221	1,353	2,044	2,060
Indonesia	10,119	7,311	8,427	9,497	11,021
India	1,189	1,297	1,530	1,804	1,978
Middle East and North Africa	29,927	18,427	20,197	19,602	23,054
Iran	2,506	1,383	1,556	1,164	1,792
Saudi Arabia	10,245	5,205	7,311	6,348	7,048
Kuwait	1,162	1,157	1,796	1,590	2,339
Oman	3,066	1,616	1,414	1,690	1,530
United Arab Emirates	8,916	5,947	5,408	5,324	6,051
Subsaharan Africa	1,052	1,356	1,435	2,011	2,043
Communist Countries	8,480	8,232	10,628	13,863	15,584
China	6,483	5,652	7,401	9,859	11,146
U.S.S.R.	1,429	1,972	2,352	2,766	3,005

Source: Ministry of Finance

Table 33: Japan's Trade Balance with Major Trading Partners, 1985-1989

(in millions of dollars; exports f.o.b., imports c.i.f.)

	1985	1986	1987	1988	1989
Overall Balance	$46,099	$82,743	$79,706	$77,563	$64,328
Developed Countries	49,347	68,917	71,273	67,062	$60,045
United States	39,485	51,401	52,090	47,597	44,943
Canada	-253	631	-462	-1,884	-1,838
Western Europe	12,843	19,365	22,806	25,445	21,368
Denmark	179	209	-27	-350	-441
United Kingdom	2,906	3,073	5,343	6,439	6,275
Netherlands	1,632	2,684	3,314	4,059	3,991
Belgium	995	1,521	1,837	2,265	2,024
France	759	1,297	1,143	672	-247
West Germany	4,010	6,180	6,682	7,692	6,925
Spain	256	779	987	1,324	1,385
Italy	67	228	-32	-108	-1,023
European Community	11,124	16,687	20,024	22,802	19,761
Sweden	653	864	1,250	1,343	1,088
Switzerland	-597	-684	-835	-790	-1,199
Austria	293	517	658	964	806
Australia	-2,073	-1,754	-2,723	-3,604	-3,800
New Zealand	169	147	-41	-605	-310
South Africa	-824	-874	-396	114	-318
Developing Countries	-10,958	7,993	7,126	10,546	7,227
Latin America	2,244	3,301	2,405	984	510
Mexico	-876	-407	-236	182	178
Panama	3,245	3,113	2,348	2,516	2,427
Chile	-365	-240	-264	-655	-686
Brazil	-1,225	-902	-1,154	-1,952	-1,689
Southeast Asia	2,984	12,299	14,355	19,307	20,611
South Korea	3,005	5,183	5,154	3,631	3,567
Taiwan	1,640	3,161	4,218	5,611	6,442
Hong Kong	5,742	6,087	7,312	9,598	9,307
Thailand	1,004	639	1,157	2,410	3,256
Singapore	2,267	3,113	3,961	5,972	6,287
Malaysia	-2,162	-2,137	-2,604	-1,650	-983
Philippines	-307	-133	62	-304	321
Indonesia	-7,947	-4,649	-5,437	-6,443	-7,720
India	408	802	427	277	41
Middle East and North Africa	-17,766	-8,632	-11,020	-10,164	-14,496
Iran	-1,158	-239	-512	-356	-870
Saudi Arabia	-6,355	-2,443	-4,072	-3,206	-4,285
Kuwait	374	63	-939	-860	-1,668
Oman	-2,512	-1,328	-1,152	-1,342	-1,196
United Arab Emirates	-7,752	-4,915	-4,290	-4,038	-4,755
Subsaharan Africa	1,466	822	1,459	749	849
Communist Countries	7,710	5,832	1,297	-44	-2,940
China	5,995	4,204	848	-383	-2,630
U.S.S.R.	1,321	1,178	211	364	77

Source: Ministry of Finance

Table 34: Japan's Exports by Commodity, 1985-1989

(in millions of dollars, f.o.b. value basis)

	1985	1986	1987	1988	1989
Total Exports	$175,638	$209,151	$229,221	$264,917	$275,175
Food and Live Animals	1,202	1,366	1,424	1,568	1,547
Fish and Fish Products	685	766	732	781	747
Beverages and Tobacco	114	110	121	129	140
Crude Materials (excl. fuels)	1,240	1,414	1,490	1,761	1,829
Textile Fibers and Waste	635	695	708	848	827
Mineral Fuels	539	588	782	596	972
Petroleum Products	331	379	550	359	692
Animal and Vegetable Oils and Fats	111	91	85	157	83
Chemicals	7,698	9,484	11,662	13,964	14,776
Chemical Elements and Compounds	3,243	3,953	4,979	6,000	6,627
Organic Chemicals	2,512	3,141	4,017	4,892	5,440
Inorganic Chemicals	720	799	941	1,082	1,156
Dyeing, Tanning and Coloring Materials	558	707	857	1,028	1,108
Pharmaceuticals	391	513	589	717	768
Plastic Materials	2,261	2,843	3,406	4,002	3,968
Manufactured Goods Classified Mainly by Material	28,836	29,600	30,126	35,213	35,567
Tires and Other Rubber Manufactures	1,895	2,040	2,240	3,085	3,478
Tires for Motor Vehicles	1,302	1,642	1,515	1,780	1,983
Paper and Paper Products	1,029	1,184	1,407	1,586	1,618
Textiles (excl. fibers and apparel)	4,900	5,445	5,545	5,472	5,471
Yarn and Thread	1,000	1,152	1,118	1,108	1,109
Woven Fabrics	3,361	3,706	3,742	3,598	3,572
Made-up Articles (excl. clothing)	540	586	686	767	790
Nonmetallic Mineral Manufactures	2,148	2,362	2,523	2,936	3,053
Glass and Glassware	594	686	803	940	989
Tableware	528	566	556	537	523
Iron and Steel	13,566	12,706	12,610	15,322	14,789
Bars, Rods, Shapes and Sections	1,777	1,437	1,059	] 2,027	1,983
Wire Rods	568	639	629		
Universals, Plates and Sheets	5,209	5,250	6,078	] 8,883	9,168
Hoops and Strip	1,285	1,325	1,474		
Tubes, Pipes and Fittings	4,023	3,399	2,843	4,190	3,400
Nonferrous Metals	1,467	1,564	1,772	2,142	2,246
Copper and Alloys	585	721	854	1,083	1,172
Aluminum and Alloys	615	606	668	622	635
Metal Manufactures	3,458	3,913	3,636	4,287	4,542
Finished Structural Parts and Structures	528	694	441	331	320
Nails and Industrial Fasteners	516	514	519	720	742
Tools	701	897	958	1,183	1,252

(continued)

Table 34: Japan's Exports by Commodity, 1985-1989 (continued)

(in millions of dollars, f.o.b. value basis)

	1985	1986	1987	1988	1989
Machinery and Transport Equipment	$108,387	$133,326	$149,563	$183,765	$192,134
Nonelectric Machinery	29,537	38,381	44,755	56,048	61,085
Power Generating Machinery	3,789	4,940	5,904	6,738	7,454
Steam Generating Boilers and Boiler Plants	463	567	488	235	236
Internal Combustion Engines	2,885	3,842	4,876	5,939	6,542
Agricultural Machinery	1,028	1,183	1,298	1,006	868
Tractors	746	869	920	696	613
Office Machinery	7,785	11,305	14,392	18,406	19,278
Typewriters	555	574	366	258	181
Calculators	660	556	445	426	427
Data Processing Equipment	4,625	7,270	9,375	11,393	11,242
Metalworking Machinery	2,599	3,637	3,475	3,927	4,324
Lathes	524	676	628	783	940
Textile Machinery	1,007	1,384	1,852	2,161	2,552
Sewing Machines	524	671	861	980	1,084
Printing and Bookbinding Machinery	445	616	636	837	1,033
Construction and Mining Machinery	1,995	2,187	2,179	2,400	2,523
Excavators	965	1,062	1,191	1,776	1,890
Heating and Cooling Machinery	1,588	1,793	2,032	2,530	2,716
Pumps and Centrifuges	1,678	1,912	2,159	3,876	4,146
Air and Gas Compressors	669	740	855	1,520	1,620
Mechanical Handling Equipment	1,609	1,975	1,991	2,583	2,949
Bearings	651	806	919	1,217	1,382
Electric Machinery	29,701	35,519	40,883	61,975	64,454
Electric Power Machinery	2,058	2,453	2,724	3,405	3,528
Generators	532	490	469	488	539
Motors	495	681	808	1,155	1,172
Switchboards and Control Panels	594	810	877	1,066	1,163
Insulated Wire and Cable	701	744	693	827	902
Telecommunications Equipment	12,242	13,644	15,071	*	*
Televisions	2,625	1,727	1,422	*	*
Radios	2,654	2,756	2,464	*	*
Microphones, Loudspeakers and Amplifiers	981	1,111	1,169	*	*
Household Electric Appliances	1,968	1,874	1,713	1,485	1,198
Batteries	415	579	729	930	960
Electronic Tubes and Semiconductors	4,753	6,342	8,312	12,327	14,123
Tubes	1,002	1,339	1,795	2,242	2,239
Discrete Devices	2,419	3,185	4,212	1,709	1,798
Integrated Circuits	n.a.	n.a.	n.a.	6,603	8,354
Automotive Electrical Equipment	724	944	1,146	1,269	1,482
Electronic Measuring and Controlling Instruments	1,127	1,477	1,681	2,322	2,753
Condensers	446	654	826	1,131	1,118
Transport Equipment	49,149	59,426	63,925	65,741	66,596
Railway Equipment	525	365	624	573	385
Road Motor Vehicles	34,377	42,676	44,942	48,787	48,469
Cars	25,402	32,945	35,693	38,671	38,804
Assembled Trucks and Buses	7,396	8,022	7,324	9,628	9,124
Truck and Bus Chassis with Engines	1,517	1,633	1,815	350	398

(continued)

Table 34: Japan's Exports by Commodity, 1985-1989 (continued)

(in millions of dollars, f.o.b. value basis)

	1985	1986	1987	1988	1989
Road Motor Vehicle Parts	$5,228	$8,253	$10,714	$9,131	$9,902
Motorcycles and Parts	2,626	2,686	2,628	2,368	2,458
Bicycles and Parts	308	387	402	594	532
Ships and Boats	5,929	4,879	4,360	3,947	4,428
Tankers	634	726	718	769	1,108
Cargo Ships	3,490	2,509	1,805	1,338	1,827
Miscellaneous Manufactured Goods	25,752	31,125	31,599	24,174	24,183
Clothing	728	734	665	588	563
Scientific, Medical and Optical Instruments	10,046	12,408	9,448	10,835	11,181
Copying Machines	n.a.	n.a.	n.a.	2,324	2,397
Cameras Lenses	433	542	548	508	446
Still Cameras	1,232	1,601	1,617	1,673	1,721
Measuring Instruments	676	845	945	1,195	1,228
Watches and Clocks	1,730	1,963	1,981	2,365	2,156
Stereo Equipment and Audio and Videocassette Recorders and Players	9,230	11,229	10,085	*	*
Videocassette Recorders	6,622	7,416	5,900	*	*
Photographic Supplies	n.a.	n.a.	n.a.	2,577	2,617
Film in Rolls	n.a.	n.a.	n.a.	783	763
Phonograph Records and Tapes	1,665	2,044	1,969	2,041	1,960
Musical Instruments	688	966	1,31	1,341	1,145
Plastic Products	377	464	486	556	609
Office and Stationery Supplies	412	528	582	697	706
Unclassified Commodities	1,759	2,048	2,369	3,591	3,943

*Addendum:				1988	1989
Visual Equipment				12,117	11,645
Televisions				1,779	1,666
Videocassette Recorders and Players				6,203	6,091
Television Cameras				4,136	3,888
Audio Equipment				6,373	6,222
Radios				2,212	2,181
Tape Recorders				1,599	1,619
Compact Disk Players				1,328	1,261
Microphones, Loudspeakers and Amplifiers				1,235	1,162
Parts of Audio-Visual Equipment				3,127	3,169
Telephone and Telegraph Equipment				6,629	6,425
Facsimile Machines				2,811	2,553

Source: Ministry of Finance

Table 35: Japan's Imports by Commodity, 1985-1989

(in millions of dollars, c.i.f. value basis)

	1985	1986	1987	1988	1989
Total Imports	$129,539	$126,408	$149,515	$187,354	$210,847
Food and Live Animals	14,787	18,246	20,752	26,960	28,130
Meat and Meat Products	1,927	2,587	3,338	4,313	4,899
Fresh and Frozen Beef	463	554	800	1,190	1,645
Fresh and Frozen Pork	703	1,041	1,417	1,653	1,634
Fresh and Frozen Poultry	143	274	322	437	501
Dairy Products and Eggs	241	260	292	499	539
Fish and Fish Products	4,610	6,426	7,992	10,461	10,033
Fresh and Frozen Shrimp and Lobster	1,431	1,966	2,510	2,848	2,590
Fresh and Frozen Salmon	493	571	643	1,070	932
Grains and Cereal Products	3,951	3,485	3,160	4,241	4,796
Wheat	974	886	785	1,034	1,188
Corn for Mixed Feed	1,363	1,158	1,101	1,490	1,603
Sorghum for Mixed Feed	536	462	326	422	507
Fruits and Vegetables	1,828	2,364	2,832	3,706	3,939
Fruits	1,135	1,518	1,757	2,128	2,267
Vegetables	693	846	1,075	1,578	1,672
Sugar	210	279	290	456	517
Coffee	747	1,130	838	888	891
Animal Feeds	474	671	776	1,225	1,259
Beverages and Tobacco	760	941	1,643	2,160	2,882
Alcoholic Beverages	287	372	574	855	1,313
Cigarettes	107	184	512	751	944
Crude Materials (excl. fuels)	17,715	17,292	21,751	27,633	30,248
Hides and Skins	504	563	585	761	696
Oilseeds and Oil Nuts	1,875	1,568	1,617	2,153	2,124
Soybeans	1,206	1,072	1,087	1,426	1,352
Rapeseed	435	303	329	497	514
Rubber	544	578	661	965	833
Logs and Lumber	3,700	4,044	6,227	7,122	8,201
Logs	2,781	2,923	4,348	4,546	5,055
Lumber	919	1,106	1,879	2,576	3,146
Wood Pulp	910	1,124	1,441	1,980	2,479
Textile Fibers and Waste	2,155	1,863	2,702	3,309	3,337
Wool	670	621	1,017	1,447	1,382
Cotton	1,049	817	1,137	1,318	1,382
Crude Minerals	1,088	943	1,069	1,348	1,615
Metal Ores, Concentrates and Scrap	6,232	5,763	6,120	8,488	9,333
Iron Ore and Concentrates	3,045	2,759	2,618	2,853	3,147
Nonferrous Ores	2,229	2,080	2,404	4,104	4,683
Copper	1,209	1,228	1,476	2,472	2,583
Nonferrous Scrap	546	544	773	1,090	1,099
Aluminum Scrap	335	341	531	695	686
Mineral Fuels	55,790	36,904	39,137	38,356	43,053
Coal	5,197	4,927	4,634	5,375	5,859
Coking C[illegible]	4,154	3,956	3,582	4,127	4,312

(continued)

Table 35: Japan's Imports by Commodity, 1985-1989 (continued)

(in millions of dollars, c.i.f. value basis)

	1985	1986	1987	1988	1989
Petroleum and Products	$40,575	$24,117	$27,445	$25,807	$29,823
Crude Petroleum	34,599	19,481	20,663	18,852	21,544
Petroleum Products	5,976	4,636	6,782	6,955	8,279
Residual Fuel Oil	2,020	1,093	1,477	1,165	1,308
Natural and Manufactured Gas	10,006	7,843	7,022	7,128	7,304
Liquefied Petroleum Gas	2,806	2,092	1,970	1,953	1,842
Liquefied Methane Gas	7,200	5,751	5,052	5,170	5,457
Animal and Vegetable Oils and Fats	329	245	271	407	423
Chemicals	8,073	9,733	11,845	14,830	15,949
Chemical Elements and Compounds	4,142	4,566	5,470	6,889	7,180
Organic Chemicals	2,411	2,849	3,494	4,555	4,659
Inorganic Chemicals	742	767	869	1,130	1,297
Dyeing, Tanning and Coloring Materials	320	420	542	652	680
Pharmaceuticals	1,292	1,724	2,110	2,658	2,731
Bulk Antibiotics	293	374	451	534	524
Plastic Materials	745	981	1,163	1,474	1,641
Manufactured Goods Classified Mainly by Material	10,886	12,390	18,055	27,340	30,767
Tires and Other Rubber Manufactures	187	310	437	602	709
Wood Manufactures	838	1,033	1,678	2,071	2,901
Plywood	n.a.	n.a.	n.a.	610	1,068
Wood Chips	604	679	819	1,069	1,357
Paper and Paper Products	545	747	873	1,144	1,258
Textiles (excl. fibers and apparel)	1,891	2,174	2,975	3,929	4,341
Nonmetallic Mineral Manufactures	1,264	1,927	2,847	4,150	4,768
Glass and Glassware	211	264	350	496	612
Diamonds	567	939	1,429	2,078	2,232
Iron and Steel	1,480	1,762	2,484	4,625	5,069
Ferroalloys	524	532	581	1,103	1,256
Universals, Plates and Sheets	347	429	607	2,201	2,463
Nonferrous Metals	4,042	3,655	5,644	9,312	9,915
Precious Metals	713	825	1,414	1,712	1,506
Copper and Alloys	592	473	691	1,274	1,698
Aluminum and Alloys	1,861	1,641	2,669	5,030	5,080
Metal Manufactures	512	637	882	1,245	1,497
Machinery and Transport Equipment	11,106	13,283	17,264	24,727	29,894
Nonelectric Machinery	4,728	5,318	6,746	9,322	11,467
Power Generating Machinery	896	897	1,136	1,292	1,421
Aircraft Engines	630	666	813	924	937
Office Machinery	1,545	1,706	2,218	3,279	4,366
Computers, Peripheral Equipment and Parts	1,509	1,671	2,169	3,210	4,286
Metalworking Machinery	233	295	277	436	525
Heating and Cooling Machinery	175	222	270	427	513
Pumps and Centrifuges	317	327	408	521	609
Electric Machinery	3,795	4,506	5,894	9,289	11,488
Electric Power Machinery	333	377	470	731	917

(continued)

Table 35: Japan's Imports by Commodity, 1985-1989 (continued)

(in millions of dollars, c.i.f. value basis)

	1985	1986	1987	1988	1989
Electronic Tubes and Semiconductors	$1,016	$1,216	$1,531	$2,284	$2,860
Integrated Circuits	n.a.	n.a.	n.a.	1,758	2,254
Telecommunications Equipment	438	619	975	*	*
Electronic Measuring and Controlling Instruments	643	762	918	1,530	1,808
Transport Equipment	2,583	3,459	4,624	6,117	6,939
Cars	539	1,070	2,031	3,038	4,009
Automotive Parts	188	245	340	430	559
Aircraft	1,484	1,777	1,742	2,024	1,656
Miscellaneous Manufactured Goods	6,349	8,634	13,396	18,702	23,722
Furniture	318	431	665	1,033	1,241
Travel Goods and Handbags	192	327	514	778	1,035
Clothing	1,995	2,853	4,649	6,702	8,942
Footwear	391	490	784	1,108	1,117
Scientific, Medical and Optical Instruments	929	952	1,208	1,310	1,593
Watches and Clocks	251	330	427	624	889
Photographic Supplies	342	431	489	584	521
Phonograph Records and Tapes	178	215	304	471	549
Plastic Products	158	229	341	473	561
Sporting Goods	286	374	558	810	1,034
Art Works and Antiques	244	411	989	1,712	2,565
Unclassified Commodities	3,744	8,742	5,402	6,240	5,780
Nonmonetary Gold	2,027	6,984	3,467	4,102	3,491
*Addendum:					
Audio-Visual Equipment and Parts				1,421	1,922
Telephone and Telegraph Equipment				513	687

Source: Ministry of Finance

Table 36: Japan's Dollar-Based Trade with the United States, 1985-1989

(in millions of dollars, customs clearance basis, seasonally unadjusted)

		Exports (f.o.b.)	Change Over Year-Earlier Period	Imports (c.i.f.)	Change Over Year-Earlier Period	Trade Balance
1985		$65,278	8.9%	$25,793	-4.0%	$39,485
1986		80,456	23.3	29,054	12.6	51,401
1987		83,580	3.9	31,491	8.4	52,090
1988		89,634	7.2	42,037	33.5	47,597
1989		93,189	4.0	48,246	14.8	44,943
1988	January	5,851	4.5	2,878	24.0	2,973
	February	6,816	9.7	3,423	52.4	3,393
	March	7,192	16.2	3,789	56.6	3,404
	April	7,354	-1.0	3,223	40.1	4,132
	May	6,908	-0.6	3,509	39.9	3,398
	June	7,349	8.1	3,727	33.9	3,622
	July	7,961	4.2	3,471	21.8	4,490
	August	6,982	9.2	3,737	40.0	3,245
	September	8,113	6.8	3,459	26.6	4,654
	October	8,352	8.0	3,531	28.4	4,821
	November	8,063	14.9	3,637	29.5	4,426
	December	8,695	8.4	3,654	17.8	5,041
1989	January	6,505	11.2	3,533	22.8	2,972
	February	7,571	11.1	3,424	0.0	4,147
	March	8,650	20.3	4,643	22.5	4,008
	April	7,923	7.7	3,368	4.5	4,555
	May	7,140	3.4	4,383	24.9	2,757
	June	7,935	8.0	4,313	15.7	3,622
	July	8,097	1.7	4,236	22.0	3,861
	August	7,340	5.1	4,326	15.8	3,014
	September	8,681	7.0	3,900	12.7	4,781
	October	7,918	-5.2	4,091	15.9	3,828
	November	7,657	-5.0	4,095	12.6	3,563
	December	7,772	-10.6	3,935	7.7	3,837

Source: Ministry of Finance

Table 37: Japan's Yen-Based Trade with the United States, 1985-1989

(in billions of yen, customs clearance basis, seasonally unadjusted)

		Exports (f.o.b.)	Change Over Year-Earlier Period	Imports (c.i.f.)	Change Over Year-Earlier Period	Trade Balance
1985		Y15,583	9.6%	Y6,213	-2.4%	Y9,369
1986		13,564	-13.0	4,918	-20.9	8,646
1987		12,148	-10.4	4,582	-6.8	7,566
1988		11,487	-5.4	5,388	17.6	6,099
1989		12,816	11.6	6,632	23.1	6,184
1988	January	739	-16.7	363	-1.7	376
	February	877	-7.6	440	28.3	437
	March	925	-2.6	488	31.3	438
	April	924	-15.3	405	19.8	520
	May	862	-11.5	438	24.7	424
	June	920	-5.1	467	17.6	454
	July	1,045	-7.5	456	8.3	589
	August	930	-3.7	498	23.6	432
	September	1,089	0.3	464	18.8	624
	October	1,103	-1.3	468	17.8	635
	November	1,010	4.1	456	17.2	554
	December	1,064	0.3	447	8.5	617
1989	January	819	10.9	444	22.4	375
	February	973	10.9	440	-0.1	533
	March	1,108	19.7	594	21.9	514
	April	1,047	13.2	445	9.9	602
	May	957	11.0	586	33.9	370
	June	1,136	23.4	617	32.2	519
	July	1,146	9.6	600	31.5	546
	August	1,030	10.8	607	22.0	423
	September	1,260	15.7	566	21.9	694
	October	1,131	2.5	583	24.6	547
	November	1,093	8.2	584	28.1	509
	December	1,119	5.2	566	26.8	553

Source: Ministry of Finance

Table 38: Japan's Foreign Direct Investment by Country, FY 1985-FY 1989

(in millions of dollars)

	FY 1985	FY 1986	FY 1987	FY 1988	FY 1989	Total March 31, 1990
United States	$5,395	$10,165	$14,704	$21,701	$32,540	$104,400
Canada	100	276	653	626	1,362	4,593
North America	5,495	10,441	15,357	22,328	33,902	108,993
United Kingdom	375	984	2,473	3,956	5,239	15,793
Netherlands	613	651	829	2,359	4,547	10,072
Luxembourg	300	1,092	1,764	657	654	5,383
West Germany	172	210	403	409	1,083	3,448
France	67	152	330	463	1,136	2,899
Switzerland	60	91	224	454	397	1,829
Spain	91	86	283	161	501	1,546
Belgium	84	50	70	164	326	1,353
Europe	1,930	3,469	6,576	9,116	14,808	44,972
Indonesia	408	250	545	586	631	10,435
Hong Kong	131	502	1,072	1,662	1,898	8,066
Singapore	339	302	494	747	1,902	5,715
South Korea	134	436	647	483	606	3,854
Thailand	48	124	250	859	1,276	3,268
Malaysia	79	158	163	387	673	2,507
China	100	226	1,226	296	438	2,474
Taiwan	114	291	367	372	494	2,285
Philippines	61	21	72	134	202	1,322
Asia	1,435	2,327	4,868	5,569	8,238	40,465
Panama	1,533	2,401	2,305	1,712	2,044	14,902
Caymans	132	930	1,197	2,609	1,658	6,743
Brazil	314	270	229	510	349	5,946
Bahamas	298	792	734	737	620	3,338
Mexico	101	226	28	87	36	1,707
Bermuda	148	16	36	337	228	1,219
Latin America	2,616	4,737	4,816	6,428	5,238	36,855
Australia	468	881	1,222	2,413	4,256	12,394
Oceania	525	992	1,413	2,669	4,618	13,933
Liberia	159	289	267	648	643	4,301
Africa	172	309	272	653	671	5,275
Neutral Zone (Saudi Arabia/Kuwait)	34	41	54	20	32	1,415
Iran	0	---	---	1	1	1,006
Middle East	45	44	62	259	66	3,404
Total	12,217	22,320	33,364	47,022	67,540	253,896

Source: Ministry of Finance

Table 39: Japan's Foreign Direct Investment by Industry, FY 1985-FY 1989

(in millions of dollars)

	FY 1985	FY 1986	FY 1987	FY 1988	FY 1989	Total March 31, 1990
Manufacturing Sector	$2,352	$3,806	$7,832	$13,805	$16,284	$66,127
Food Products	90	127	328	419	1,300	3,265
Textiles	28	63	206	317	533	3,203
Wood and Paper Products	15	57	317	604	555	2,654
Chemicals	133	355	910	1,292	2,109	8,649
Metals	385	328	786	1,367	1,591	9,261
Nonelectric Machinery	352	626	687	1,432	1,762	6,479
Electric Machinery	513	987	2,421	3,041	4,480	14,676
Transport Equipment	627	828	1,473	1,281	2,053	9,009
Other	208	435	703	4,051	1,901	8,932
Nonmanufacturing Sector	9,536	17,949	25,080	32,634	50,517	182,516
Agriculture and Forestry	12	15	97	162	151	1,205
Fisheries	42	52	44	94	47	678
Mining	598	669	511	1,013	1,262	15,211
Construction	94	250	87	309	646	2,089
Trade and Sales	1,550	1,861	2,269	3,204	5,148	25,159
Banking, Finance and Insurance	3,805	7,240	10,673	13,104	15,395	57,271
Services	665	1,560	2,780	3,732	10,616	23,375
Transportation	1,240	1,925	2,145	2,372	2,927	15,269
Real Estate	1,207	3,997	5,428	8,641	14,143	34,742
Other	322	379	1,047	3	180	7,515
Branch Offices	329	566	452	584	739	4,659
Other Transactions*	---	---	---	---	---	595
Total	12,217	22,320	33,364	47,022	67,540	253,896

*Certain overseas real estate transactions have been excluded from Japan's foreign direct investment data since December 1, 1980 because of changes in the Foreign Exchange and Foreign Trade Control Law.

Source: Ministry of Finance

Table 40: U.S. International Transactions, 1985-1989

(in millions of dollars, IMF value basis)

	1985	1986	1987	1988	1989
Merchandise Trade Balance	$-122,148	$-145,058	$-159,500	$-126,986	$-114,864
Exports	215,935	223,367	250,266	320,337	360,465
Imports	338,083	368,425	409,766	447,323	475,329
Services Balance	15,289	15,675	11,760	13,129	19,550
Military	-4,096	-4,907	-3,530	-5,452	-6,320
Travel	-7,492	-6,473	-6,656	-4,163	-545
Other Transportation	-3,296	-2,466	-1,642	103	1,204
Investment Income	16,166	10,969	5,326	1,610	-913
Direct Investments	22,216	25,521	31,088	33,071	39,613
Portfolio Investments	-6,050	-14,552	-25,761	-31,461	-40,525
Fees and Royalties	5,104	6,192	7,697	8,804	9,570
Other Services	8,904	12,359	10,565	12,228	16,553
Unilateral Transfers Balance	-15,473	-16,009	-14,575	-15,005	-14,720
Current Account Balance	-122,332	-145,393	-162,314	-128,862	-110,034
Private Capital Flows (net)	110,053	95,690	100,169	98,695	102,876
Direct Investments (net)	5,860	15,412	15,849	42,218	40,522
Securities (net)	63,914	70,507	29,226	38,746	47,581
Banking Flows (net)	39,722	19,808	46,907	13,913	10,515
Other Flows (net)	557	-10,037	8,187	3,817	4,258
U.S. Government Assets (other than official reserves) (net)	-2,821	-2,022	997	2,969	1,185
U.S. Official Reserve Assets (net)	-3,858	312	9,149	-3,912	-25,293
Foreign Official Assets (net)	-1,083	35,588	45,210	39,515	8,823
Statistical Discrepancy	20,041	15,824	6,790	-8,404	22,443

Note: For capital transactions, credits (+) indicate net inflows and debits (-) indicate net outflows.

Source: Department of Commerce

Table 41: U.S. Transactions with Japan, 1985-1989

(in millions of dollars, IMF value basis)

	1985	1986	1987	1988	1989
Merchandise Trade Balance	$-43,508	$-54,398	$-56,959	$-52,618	$-49,782
Exports	22,145	26,354	27,619	37,183	43,673
Imports	65,653	80,752	84,578	89,801	93,455
Services Balance	-1,631	694	-171	2,093	5,971
Military	-1,264	-1,830	-1,705	-1,655	-1,463
Travel	1,465	2,542	2,369	3,054	4,810
Other Transportation	-580	-727	256	414	1,007
Investment Income	-2,381	-1,628	-3,718	-3,215	-2,318
Direct Investments	56	2,378	1,475	1,374	1,351
Portfolio Investments	-2,437	-4,005	-5,193	-4,588	-3,670
Fees and Royalties	936	1,066	1,591	2,061	2,075
Other Services	193	1,271	1,036	1,434	1,860
Unilateral Transfers Balance	-68	-87	-93	-108	-134
Current Account Balance	-45,208	-53,792	-57,223	-50,633	-43,945
U.S. Government and Private Assets in Japan (net)	-5,973	-27,145	-17,360	-41,971	-26,028
Japanese Government and Private Assets in United States (net)	31,376	51,253	42,716	87,016	23,372
Statistical Discrepancy	19,806	29,684	31,867	5,589	46,601

Note: For capital transactions, credits (+) indicate net inflows and debits (-) indicate net outflows.

Source: Department of Commerce

Table 42: U.S. Exports and Imports, 1985-1989*

(in millions of dollars, seasonally unadjusted)

		Exports (f.a.s.)	Change Over Year-Earlier Period	Imports (Customs)	Change Over Year-Earlier Period	Trade Balance
1985		$218,828	0.4%	$345,276	6.0%	$-126,448
1986		227,159	6.6	365,438	5.8	-138,279
1987		254,122	11.9	406,241	11.2	-152,119
1988		322,426	26.9	440,952	8.5	-118,526
1989		363,812	12.8	473,211	7.3	-109,399
1988	January	23,162	33.5	33,035	7.3	-10,496
	February	24,316	29.0	35,494	19.1	-12,556
	March	29,343	34.4	36,999	14.0	-9,301
	April	26,728	29.3	34,961	8.3	-9,027
	May	28,193	35.8	36,108	8.9	-8,415
	June	26,803	23.9	38,541	9.0	-10,969
	July	25,186	17.8	35,397	-1.2	-8,860
	August	26,539	32.2	37,545	11.0	-10,365
	September	27,066	27.8	36,304	7.8	-9,043
	October	28,544	25.3	38,795	1.9	-8,682
	November	27,565	18.4	38,389	9.0	-10,157
	December	28,982	19.2	39,384	10.1	-10,655
1989	January	27,541	18.9	36,179	9.5	-8,638
	February	27,927	14.9	36,549	3.0	-8,622
	March	33,243	13.3	40,197	8.7	-6,954
	April	31,052	16.2	38,243	9.4	-7,191
	May	31,496	11.7	40,959	13.4	-9,463
	June	31,820	18.7	40,544	5.2	-8,724
	July	28,708	14.0	39,290	11.0	-10,582
	August	29,406	10.8	40,440	7.7	-11,034
	September	29,710	9.8	38,680	6.5	-8,971
	October	31,756	11.3	43,536	12.2	-11,780
	November	30,279	9.8	41,033	6.9	-10,754
	December	30,874	6.5	37,561	-4.6	-6,687

*The export and the import data for 1985 through 1989 reflect revisions not necessarily incorporated in other tables. The export statistics cover domestic and foreign merchandise, including Department of Defense shipments.

Source: Department of Commerce

Table 43: U.S. Exports by Major Market, 1985-1989

(in millions of dollars, f.a.s. value basis)

	1985	1986	1987	1988	1989
Total Exports	$218,828	$227,159	$254,122	$322,426	$363,812
Developed Countries	140,054	151,626	165,375	206,805	234,575
Japan	22,631	26,882	28,249	37,725	44,494
Canada	53,287	55,512	59,814	71,622	78,809
Western Europe	56,763	61,642	69,718	87,858	100,165
United Kingdom	11,273	11,418	14,114	18,364	20,837
West Germany	9,050	10,561	11,748	14,348	16,862
France	6,096	7,216	7,943	9,970	11,579
Netherlands	7,269	7,848	8,217	10,117	11,364
Belgium-Luxembourg	4,918	5,399	6,189	7,411	8,522
Italy	4,625	4,838	5,530	6,775	7,215
Spain	2,524	2,615	3,148	4,215	4,796
Ireland	1,342	1,434	1,810	2,183	2,483
European Community	45,776	53,154	60,575	75,755	86,331
Switzerland	2,288	2,977	3,151	4,196	4,911
Sweden	1,925	1,871	1,894	2,700	3,139
Turkey	1,295	1,160	1,483	1,850	2,003
Norway	666	937	842	929	1,037
Australia	5,441	5,551	5,495	6,973	8,331
South Africa	1,205	1,158	1,281	1,688	1,659
Developing Countries	71,671	70,637	81,691	106,727	117,769
Western Hemisphere	46,909	41,949	46,869	43,859	49,080
Mexico	13,635	12,392	14,582	20,628	24,982
Brazil	3,140	3,885	4,040	4,267	4,804
Venezuela	3,399	3,141	3,586	4,612	3,025
Colombia	1,468	1,319	1,412	1,754	1,924
Dominican Republic	742	921	1,142	1,359	1,645
East Asian Newly Industrialized Countries	16,918	18,290	23,547	34,816	38,429
South Korea	5,956	6,355	8,099	11,232	13,459
Taiwan	4,700	5,524	7,413	12,129	11,335
Singapore	3,476	3,380	4,053	5,768	7,345
Hong Kong	2,786	3,030	3,983	5,687	6,291
Other Developing Countries	23,735	21,270	23,164	28,052	30,260
Saudi Arabia	4,474	3,449	3,373	3,776	3,574
Malaysia	1,539	1,730	1,897	2,142	2,871
Israel	2,580	2,239	3,130	3,244	2,827
Egypt	2,323	1,982	2,210	2,333	2,612
India	1,642	1,536	1,463	2,500	2,458
Thailand	849	936	1,544	1,962	2,288
Philippines	1,379	1,363	1,599	1,878	2,202
Indonesia	795	946	767	1,059	1,247
Iraq	427	528	683	1,157	1,169
Nigeria	676	409	295	357	490
Eastern Europe and Communist Countries	7,092	5,127	5,723	8,686	11,073
China	3,856	3,106	3,497	5,021	5,755
Soviet Union	2,423	1,248	1,480	2,769	4,285

Source: Department of Commerce

Table 44: U.S. Imports by Major Supplier, 1985-1989

(in millions of dollars, Customs value basis)

	1985	1986	1987	1988	1989
Total Imports	$345,276	$365,438	$406,241	$440,952	$473,211
Developed Countries	223,310	245,956	256,553	277,575	289,882
Japan	68,783	81,911	84,575	89,519	93,553
Canada	69,006	68,253	71,085	81,398	87,953
Western Europe	79,756	89,825	95,496	100,443	101,764
United Kingdom	14,937	15,396	17,341	17,976	18,319
West Germany	20,239	25,124	27,069	26,362	24,833
France	9,482	10,129	10,730	12,509	13,014
Netherlands	4,081	4,066	3,964	4,559	4,810
Belgium-Luxembourg	3,387	4,006	4,171	4,493	4,555
Italy	9,674	10,607	11,040	11,576	11,933
Spain	2,515	2,702	2,839	3,204	3,317
Ireland	901	1,003	1,112	1,375	1,566
European Community	67,822	75,736	81,188	84,939	85,153
Switzerland	3,476	5,253	4,249	4,611	4,714
Sweden	4,124	4,420	4,758	4,985	4,892
Turkey	602	633	821	979	1,372
Norway	1,164	1,079	1,404	1,446	1,991
Australia	2,837	2,632	3,007	3,541	3,873
South Africa	2,071	2,365	1,346	1,513	1,531
Developing Countries	116,164	117,231	141,129	152,702	169,273
Western Hemisphere	46,909	41,949	46,869	51,142	57,332
Mexico	19,132	17,302	20,271	23,260	27,162
Brazil	7,526	6,813	7,865	9,294	8,410
Venezuela	6,537	5,097	5,579	5,157	6,771
Colombia	1,331	1,874	2,232	2,161	2,555
Dominican Republic	982	1,085	1,163	1,410	1,646
East Asian Newly Industrialized Countries	39,066	46,136	57,664	63,060	62,774
South Korea	10,013	12,729	16,987	20,105	19,737
Taiwan	16,396	19,791	24,622	24,714	24,313
Singapore	4,260	4,725	6,201	7,973	9,003
Hong Kong	8,396	8,891	9,854	10,238	9,722
Other Developing Countries	30,189	29,147	36,596	38,500	49,167
Saudi Arabia	1,907	3,612	4,433	5,620	7,157
Malaysia	2,300	2,421	2,921	3,692	4,744
Israel	2,123	2,418	2,639	2,972	3,239
Egypt	79	112	465	220	227
India	2,295	2,283	2,529	2,940	3,315
Thailand	1,428	1,748	2,220	3,210	4,380
Philippines	2,145	1,972	2,264	2,666	3,068
Indonesia	4,569	3,312	3,394	3,150	3,529
Iraq	474	440	495	1,488	2,415
Nigeria	3,002	2,530	3,573	3,279	5,284
Eastern Europe and Communist Countries	5,802	6,774	8,219	10,675	14,056
China	3,862	4,771	6,293	8,511	11,990
Soviet Union	409	558	425	586	709

Source: Department of Commerce

Table 45: U.S. Trade Balance with Major Trading Partners, 1985-1989

(in millions of dollars; exports f.a.s., imports Customs)

	1985	1986	1987	1988	1989
Overall Trade Balance	$-126,448	$-138,279	$-152,119	$-118,526	$-109,399
Developed Countries	-83,256	-94,330	-91,178	-70,770	-55,306
Japan	-46,152	-55,030	-56,326	-51,794	-49,059
Canada	-15,719	-12,741	-11,271	-9,776	-9,144
Western Europe	-22,993	-28,183	-25,778	-12,585	-1,599
United Kingdom	-3,664	-3,978	-3,227	388	2,518
West Germany	-11,189	-14,563	-15,322	-12,014	-7,970
France	-3,386	-2,913	-2,787	-2,539	-1,435
Netherlands	3,188	3,782	4,253	5,558	6,554
Belgium-Luxembourg	1,530	1,393	2,019	2,917	3,967
Italy	-5,049	-5,769	-5,510	-4,801	-4,718
Spain	9	-87	310	1,012	1,479
Ireland	441	431	699	809	917
European Community	-18,828	-22,582	-20,613	-9,183	1,178
Switzerland	-1,188	-2,276	-1,098	-415	197
Sweden	-2,199	-2,549	-2,865	-2,285	-1,753
Turkey	693	526	661	871	632
Norway	-498	-142	-562	-517	-955
Australia	2,604	2,920	2,488	3,432	4,458
South Africa	-866	-1,206	-64	175	128
Developing Countries	-44,492	-46,595	-59,438	-45,976	-51,505
Western Hemisphere	-15,890	-10,872	-11,890	-7,283	-8,252
Mexico	-5,497	-4,910	-5,689	-2,631	-2,180
Brazil	-4,386	-2,928	-3,825	-5,028	-3,606
Venezuela	-3,138	-1,956	-1,993	-546	-3,745
Colombia	1,368	-555	-821	-406	-631
Dominican Republic	-240	-164	-21	-50	-1
East Asian Newly Industrialized Countries	-22,148	-27,846	-34,117	-28,214	-24,345
South Korea	-4,057	-6,374	-8,888	-8,873	-6,278
Taiwan	-11,697	-14,267	-17,209	-12,585	-12,978
Singapore	-784	-1,345	-2,148	-2,206	-1,659
Hong Kong	-5,610	-5,861	-5,871	-4,550	-3,431
Other Developing Countries	-6,454	-7,877	-13,431	-10,448	-18,907
Saudi Arabia	2,567	-163	-1,060	-1,844	-3,583
Malaysia	-761	-691	-1,025	-1,550	-1,874
Israel	457	-179	491	273	-412
Egypt	2,244	1,870	1,745	2,112	2,385
India	-653	-747	-1,065	-439	-857
Thailand	-2,277	-811	-676	-1,248	-2,091
Philippines	-766	-609	-665	-788	-866
Indonesia	-3,774	-2,366	-2,627	-2,092	-2,282
Iraq	-45	87	189	-331	-1,246
Nigeria	-2,326	-2,122	-3,278	-2,922	-4,794
Eastern Europe and Communist Countries	1,290	-1,647	-2,496	-1,989	-2,983
China	-6	-1,665	-2,796	-3,490	-6,235
Soviet Union	2,014	689	1,055	2,183	3,574

Source: Department of Commerce

Table 46: U.S. Exports by End-Use Category, 1988-1989

(in millions of dollars, f.a.s. value)

	1988	1989
Total Exports	$322,498	$362,808
Food, Feed and Beverages	32,856	35,504
Wheat	5,104	6,125
Rice and Other Food Grains	849	1,052
Corn	5,101	6,824
Sorghum, Barley and Oats	845	1,165
Other Animal Feeds	3,428	2,906
Soybeans	4,884	4,027
Other Oilseeds	1,020	899
Meat and Meat Products	2,635	2,957
Fish and Fish Products	2,211	2,359
Fruits and Fruit Products	1,922	2,027
Vegetables and Vegetable Products	1,028	1,176
Industrial Supplies and Materials	86,732	94,388
Raw Cotton	1,979	2,261
Unmanufactured Tobacco	1,262	1,338
Hides and Skins (incl. furskins)	1,850	1,742
Metallurgical-Grade Coal	2,735	3,006
Other Coal	1,363	1,782
Fuel Oil	1,684	1,774
Other Petroleum Products	2,396	3,218
Nuclear Fuel Materials and Fuels	747	1,326
Logs, Lumber, Plywood and Veneers	4,510	4,973
Paper Base Stocks	4,017	4,355
Newsprint and Other Paper Products	3,490	3,710
Synthetic Fibers, Yarn and Fabric	2,288	2,302
Plastic Materials	6,617	5,784
Fertilizers, Pesticides and Insecticides	4,345	4,145
Industrial Inorganic Chemicals	2,026	3,069
Industrial Organic Chemicals	7,610	9,023
Iron Ore, Steel Scrap and Ferroalloys	1,685	2,092
Steel Slabs, Bars, Wire Rods, Plates and Sheets	1,200	2,208
Steel Strip, Wire, Shapes, Pipes, Tubes and Fasteners	1,019	1,628
Aluminum	2,925	3,260
Copper	1,353	1,158
Nonmonetary Gold	5,170	1,886
Other Precious Metals	661	1,126
Other Nonferrous Metals	1,552	1,946
Fabricated Metal Products	2,754	2,713
Manufactured Mineral Supplies	980	1,397
Blank Audio and Video Tapes and Other Media	1,245	1,386
Capital Goods	115,417	132,368
Electric Machinery	10,827	10,584
Generators, Transformers and Accessories	2,105	1,788
Other Electric Apparatus and Parts	8,721	8,797
Nonelectric Machinery	81,899	93,689
Drilling and Oilfield Equipment	2,408	2,866

(continued)

Table 46: U.S. Exports by End-Use Category, 1988-1989 (continued)

(in millions of dollars, f.a.s. value)

	1988	1989
Excavating, Paving and Construction Machinery	$1,980	$2,963
Nonfarm Tractors and Parts	1,366	1,607
Industrial Engines, Pumps, Compressors and Generators	3,805	5,662
Food and Tobacco Processing Machinery	685	1,088
Machine Tools, Metalworking, Molding and Rolling Mill Machinery	2,544	2,867
Textile and Sewing Machinery	705	1,139
Woodworking, Glassmaking and Plastic and Rubber Molding Machinery	1,473	1,327
Pulp, Paper, Printing and Packaging Machinery	1,682	1,828
Measuring, Testing and Control Instruments	5,282	4,640
Materials Handling Equipment	1,538	1,949
Photo and Service Industry Machinery	2,380	3,229
Agricultural Machinery and Equipment	2,377	2,100
Computers	5,372	7,355
Computer Peripherals, Accessories and Parts	18,059	16,161
Semiconductors	8,749	11,807
Telecommunications Equipment	6,337	7,927
Other Office and Business Machines	1,724	2,157
Scientific, Hospital and Medical Equipment	5,248	6,556
Transportation Equipment	22,691	28,095
Civilian Aircraft	10,431	13,588
Parts for Civilian Aircraft	5,588	6,787
Engines for Civilian Aircraft	4,865	6,137
Marine Engines and Parts	1,232	775
Automotive Vehicles, Parts and Engines	30,208	30,437
Cars	9,014	10,037
Trucks, Buses and Special Vehicles	3,986	3,619
Automotive Engines and Parts	3,346	3,171
Other Automotive Parts and Accessories (incl. tires)	13,863	13,611
Consumer Goods	26,000	34,084
Manufactured Consumer Nondurables	13,138	15,637
Textile Apparel, Footwear and Household Goods	1,682	2,134
Pharmaceutical Preparations	4,244	4,338
Printed Material	1,873	2,172
Cigarettes and Other Tobacco Manufactures	2,926	3,633
Manufactured Consumer Durables	11,352	16,773
Household and Kitchen Appliances	1,476	2,281
Pleasure Boats and Motors	877	1,038
Toys, Sporting Goods, Bicycles and Motorcycles	1,367	2,204
Records, Tapes and Disks	793	1,148
Artwork and Antiques	1,876	3,777
Unmanufactured Consumer Goods	1,511	1,674
Gemstones	1,425	1,567
Other Exports	31,286	36,028

Source: Department of Commerce

Table 47: U.S. Imports by End-Use Category, 1988-1989

(in millions of dollars, Customs value)

	1988	1989
Total Imports	$441,926	$472,761
Food, Feed and Beverages	24,930	25,056
Coffee	2,284	2,273
Meat and Meat Products	3,475	3,310
Fish and Fish Products	5,422	5,400
Fruits and Fruit Products	3,089	2,902
Vegetables and Vegetable Products	1,232	1,619
Wine	1,906	1,796
Other Alcoholic Beverages	1,504	1,585
Industrial Supplies and Materials	118,064	132,214
Crude Oil	25,805	35,500
Fuel Oil	5,945	6,449
Other Petroleum Products	5,777	6,248
Liquefied Petroleum Gas	1,888	2,186
Natural Gas	1,876	1,852
Logs and Lumber	3,030	3,071
Paper Base Stocks	2,734	3,062
Newsprint	4,512	4,545
Other Paper and Paper Products	2,965	2,013
Cotton Fibers, Yarn and Fabric	1,218	1,259
Synthetic Fibers, Yarn and Fabric	1,977	1,971
Plastic Materials	2,414	2,733
Fertilizers, Pesticides and Insecticides	2,140	1,881
Industrial Inorganic Chemicals	1,293	1,780
Industrial Organic Chemicals	4,738	4,726
Iron Ore, Steel Scrap and Ferroalloys	1,921	1,966
Steel Slabs, Bars, Wire Rods, Plates and Sheets	6,343	6,331
Steel Strip, Wire, Shapes, Pipes, Tubes and Fasteners	4,067	3,279
Fabricated Steel Products	2,177	2,365
Bauxite and Aluminum	3,669	3,858
Copper	1,522	1,575
Nickel	1,463	1,607
Nonmonetary Gold	1,285	1,511
Other Precious Metals	2,026	2,158
Fabricated Nonferrous Metal Products	3,609	3,406
Capital Goods	101,787	113,134
Electric Machinery	11,540	11,422
Generators, Transformers and Accessories	3,581	2,365
Other Electric Apparatus and Parts	7,959	9,057
Nonelectric Machinery	82,002	90,878
Excavating, Paving and Construction Machinery	1,668	1,965
Industrial Engines, Pumps, Compressors and Generators	3,963	4,374
Machine Tools, Metalworking, Molding and Rolling Mill Machinery	3,687	4,129
Textile and Sewing Machinery	1,657	1,853
Woodworking, Glassmaking and Plastic and Rubber Molding Machinery	2,052	2,391

(continued)

Table 47: U.S. Imports by End-Use Category, 1988-1989 (continued)

(in millions of dollars, Customs value)

	1988	1989
Pulp, Paper, Printing and Packaging Machinery	$2,468	$2,767
Measuring, Testing and Control Instruments	2,944	2,660
Materials Handling Equipment	1,922	2,338
Photo and Service Industry Machinery	2,772	3,392
Agricultural Machinery and Equipment	2,519	2,672
Computers	2,994	3,365
Computer Peripherals, Accessories and Parts	15,334	18,179
Semiconductors	10,963	12,327
Telecommunications Equipment	9,407	10,446
Other Office and Business Machines	4,134	4,286
Scientific, Hospital and Medical Equipment	3,406	3,974
Transportation Equipment	8,245	10,834
Civilian Aircraft	2,713	2,913
Parts for Civilian Aircraft	2,515	2,650
Engines for Civilian Aircraft	2,344	3,967
Automotive Vehicles, Parts and Engines	87,948	85,998
Cars	47,053	44,477
Trucks, Buses and Special Vehicles	8,317	9,417
Bodies and Chassis for Trucks and Buses	2,030	1,102
Automotive Engines and Engine Parts	6,536	7,716
Automotive Tires and Tubes	2,067	2,433
Other Automotive Parts and Accessories	21,945	20,853
Consumer Goods	96,424	102,812
Manufactured Consumer Nondurables	43,117	46,467
Cotton Apparel and Household Goods	8,383	9,408
Wool Apparel and Household Goods	1,668	1,567
Other Textile Apparel and Household Goods	10,723	11,970
Nontextile Apparel and Household Goods	3,805	3,807
Footwear	5,904	5,972
Sporting and Camping Apparel, Footwear and Gear	2,567	3,291
Pharmaceutical Preparations	3,497	3,467
Printed Material	1,495	1,506
Manufactured Consumer Durables	47,763	50,326
Furniture and Household Items	4,606	3,883
Glassware and Chinaware	2,006	1,276
Cookware, Cutlery, House and Garden Wares and Tools	2,087	1,894
Household and Kitchen Appliances	3,638	3,385
Toys and Sporting Goods (incl. bicycles)	7,985	8,946
Photographic and Optical Equipment	1,479	1,390
Television Sets and Other Video Equipment	5,824	6,848
Radios, Stereo Equipment and Other Audio Equipment	5,413	6,438
Jewelry and Watches	4,533	3,516
Artworks and Antiques	1,768	2,841
Unmanufactured Consumer Goods	5,544	6,019
Gem Diamonds	4,296	4,363
Other Imports	12,775	13,548

Source: Department of Commerce

Table 48: U.S. Trade with Japan, 1985-1989

(in millions of dollars, seasonally unadjusted)

		Exports* (f.a.s.)	Change Over Year-Earlier Period	Imports (Customs)	Change Over Year-Earlier Period	Trade Balance
1985		$22,631	-4.0%	$68,783	20.4%	$-46,152
1986		26,882	18.8	81,911	19.1	-55,030
1987		28,249	5.1	84,575	3.3	-56,326
1988		37,725	33.5	89,519	5.8	-51,794
1989		44,494	17.9	93,553	4.5	-49,059
1988	January	2,715	52.1	6,357	7.7	-3,642
	February	2,958	45.4	7,098	4.0	-4,141
	March	3,193	49.3	7,408	8.9	-4,215
	April	3,047	40.4	7,245	6.0	-4,198
	May	2,961	37.6	6,685	-3.6	-3,724
	June	3,355	46.3	7,556	3.0	-4,201
	July	3,280	28.1	7,329	-0.2	-4,049
	August	3,298	24.1	7,672	5.9	-4,375
	September	3,110	28.3	7,058	4.1	-3,948
	October	3,260	36.2	8,441	6.4	-5,182
	November	3,234	22.6	8,191	14.1	-4,958
	December	3,316	10.5	8,478	13.5	-5,162
1989	January	3,125	15.1	6,733	5.9	-3,608
	February	3,258	10.1	7,763	9.4	-4,506
	March	4,104	28.5	8,440	13.9	-4,335
	April	3,677	20.7	7,537	4.0	-3,860
	May	3,610	21.9	7,927	18.6	-4,317
	June	4,073	21.4	7,871	4.2	-3,798
	July	3,866	17.8	7,855	7.2	-3,990
	August	3,917	18.8	7,859	2.4	-3,942
	September	3,502	12.6	7,743	9.7	-4,241
	October	3,699	13.5	8,603	1.9	-4,904
	November	3,759	16.2	7,774	-5.1	-4,014
	December	3,904	17.7	7,449	-12.1	-3,545

*Domestic and foreign merchandise, including Department of Defense shipments.

Source: Department of Commerce

Table 49: U.S. Exports to Japan by End-Use Category, 1988-1989

(in millions of dollars, f.a.s. value)

	1988	1989
Total Exports to Japan	$37,732	$44,479
Food, Feed and Beverages	8,005	8,481
Wheat	426	477
Corn	1,611	1,595
Sorghum, Barley and Oats	233	351
Other Animal Feeds	326	327
Soybeans	1,033	866
Other Oilseeds	58	56
Meat and Meat Products	1,379	1,634
Dairy Products and Eggs	56	36
Fish and Fish Products	1,582	1,622
Fruits and Fruit Products	535	580
Vegetables and Vegetable Products	267	277
Nuts and Nut Products	122	125
Bakery and Confectionery Products	86	87
Wine	41	57
Other Alcoholic Beverages	105	110
Industrial Supplies and Materials	13,157	15,546
Raw Cotton	482	547
Unmanufactured Tobacco	213	297
Hides and Skins (incl. furskins)	467	408
Metallurgical-Grade Coal	525	503
Other Coal	77	452
Fuel Oil	349	236
Other Petroleum Products	404	515
Natural Gas	154	158
Nuclear Fuel Materials and Fuels	476	790
Logs, Lumber, Plywood and Veneers	1,928	2,392
Manufactured Wood Supplies	46	81
Paper Base Stocks	1,057	993
Newsprint and Other Paper Products	459	513
Cotton and Other Natural Fibers, Yarn and Fabric	42	65
Synthetic Fibers, Yarn and Fabric	91	93
Synthetic Rubber	80	52
Plastic Materials	498	446
Fertilizers, Pesticides and Insecticides	295	267
Industrial Inorganic Chemicals	232	281
Industrial Organic Chemicals	908	998
Iron Ore, Steel Scrap and Ferroalloys	163	158
Steel Slabs, Bars, Wire Rods, Plates and Sheets	92	224
Steel Strip, Wire, Shapes, Pipes, Tubes and Fasteners	57	187
Aluminum	1,180	1,504
Copper	377	424
Nonmonetary Gold	99	78
Other Precious Metals	195	130
Other Nonferrous Metals	318	298
Fabricated Metal Products	165	176
Unmanufactured Nonmetallic Minerals	178	111

(continued)

Table 49: U.S. Exports to Japan by End-Use Category, 1988-1989 (continued)

(in millions of dollars, f.a.s. value)

	1988	1989
Manufactured Mineral Supplies	$105	$290
Blank Audio and Video Tapes and Other Media	142	131
Capital Goods	10,716	12,152
Electric Machinery	681	730
Generators, Transformers and Accessories	95	96
Other Electric Apparatus and Parts	587	634
Nonelectric Machinery	7,667	9,605
Excavating, Paving and Construction Machinery	69	127
Nonfarm Tractors and Parts	110	99
Industrial Engines, Pumps, Compressors and Generators	166	267
Food and Tobacco Processing Machinery	41	75
Machine Tools, Metalworking, Molding and Rolling Mill Machinery	216	231
Textile and Sewing Machinery	41	69
Woodworking, Glassmaking and Plastic and Rubber Molding Machinery	70	58
Pulp, Paper, Printing and Packaging Machinery	124	122
Measuring, Testing and Control Instruments	842	656
Materials Handling Equipment	59	72
Photo and Service Industry Machinery	198	291
Agricultural Machinery and Equipment	47	70
Computers	803	1,246
Computer Peripherals, Accessories and Parts	1,743	1,859
Semiconductors	841	1,171
Telecommunications Equipment	621	978
Other Office and Business Machines	102	192
Scientific, Hospital and Medical Equipment	775	716
Transportation Equipment	2,368	1,818
Civilian Aircraft	1,306	720
Parts for Civilian Aircraft	523	608
Engines for Civilian Aircraft	430	374
Marine Engines and Parts	92	71
Automotive Vehicles, Parts and Engines	826	1,123
Cars	348	481
Trucks, Buses and Special Vehicles	46	66
Automotive Tires and Tubes	147	178
Automotive Parts and Accessories (incl. engines)	285	397
Consumer Goods	3,701	5,571
Manufactured Consumer Nondurables	2,010	2,417
Textile Apparel, Footwear and Household Goods	136	183
Nontextile Apparel, Footwear and Household Goods	77	109
Sporting and Camping Apparel, Footwear and Gear	60	27
Pharmaceutical Preparations	849	870
Printed Material	105	137
Toiletries and Cosmetics	40	66
Cigarettes and Other Tobacco Manufactures	614	874

(continued)

Table 49: U.S. Exports to Japan by End-Use Category, 1988-1989 (continued)

(in millions of dollars, f.a.s. value)

	1988	1989
Manufactured Consumer Durables	$1,460	$2,927
Furniture	37	54
Cookware, Cutlery, House and Garden Wares and Tools	39	59
Household and Kitchen Appliances	35	94
Floor Coverings	37	61
Pleasure Boats and Motors	56	97
Toys, Sporting Goods, Bicycles and Motorcycles	286	465
Musical Instruments and Photographic and Optical Equipment	75	104
Television Sets and Other Video Equipment	30	64
Radios, Stereo Equipment and Other Audio Equipment	16	62
Records, Tapes and Disks	121	220
Jewelry and Watches	89	153
Artwork and Antiques	499	1,258
Unmanufactured Consumer Goods	231	227
Gemstones	226	220
Other Exports	1,326	1,606

Source: Department of Commerce

Table 50: U.S. Imports from Japan by End-Use Category, 1988-1989

(in millions of dollars, Customs value)

	1988	1989
Total Imports from Japan	$89,762	$93,482
Food, Feed and Beverages	406	348
Fish and Fish Products	200	176
Industrial Supplies and Materials	8,495	8,563
Cotton Fibers, Yarn and Fabric	124	119
Synthetic Fibers, Yarn and Fabric	406	358
Plastic Materials	509	564
Industrial Inorganic Chemicals	144	173
Industrial Organic Chemicals	720	688
Steel Slabs, Bars, Wire Rods, Plates and Sheets	1,584	1,674
Steel Strip, Wire, Shapes, Pipes, Tubes and Fasteners	841	685
Fabricated Steel Products	590	575
Fabricated Nonferrous Metal Products	444	415
Blank Audio and Video Tapes and Other Media	752	671
Capital Goods	32,834	36,872
Electric Machinery	3,468	3,122
Generators, Transformers and Accessories	807	411
Other Electric Apparatus and Parts	2,661	2,711
Nonelectric Machinery	28,810	32,973
Drilling and Oilfield Equipment	373	251
Specialized Mining and Oil Processing Equipment	563	478
Excavating, Paving and Construction Machinery	436	433
Nonfarm Tractors and Parts	105	269
Industrial Engines, Pumps, Compressors and Generators	1,140	1,163
Food and Tobacco Processing Machinery	94	106
Machine Tools, Metalworking, Molding and Rolling Mill Machinery	1,742	2,056
Textile and Sewing Machinery	403	543
Woodworking, Glassmaking and Plastic and Rubber Molding Machinery	557	813
Pulp, Paper, Printing and Packaging Machinery	348	472
Measuring, Testing and Control Instruments	818	764
Materials Handling Equipment	524	650
Photo and Service Industry Machinery	988	1,307
Agricultural Machinery and Equipment	494	438
Computers	648	619
Computer Peripherals, Accessories and Parts	7,050	7,929
Semiconductors	3,278	3,876
Telecommunications Equipment	3,851	4,984
Other Office and Business Machines	2,511	2,539
Scientific, Hospital and Medical Equipment	984	1,163
Transportation Equipment	557	778
Parts for Civilian Aircraft	322	387
Engines for Civilian Aircraft	58	97
Railroad Equipment	89	72
Marine Engines and Parts	63	182

(continued)

Table 50: U.S. Imports from Japan by End-Use Category, 1988-1989 (continued)

(in millions of dollars, Customs value)

	1988	1989
Automotive Vehicles, Parts and Engines	$32,789	$33,685
Cars	19,873	20,140
Trucks, Buses and Special Vehicles	3,477	2,855
Bodies and Chassis for Trucks and Buses	263	86
Automotive Engines and Engine Parts	2,011	3,087
Automotive Tires and Tubes	641	818
Other Automotive Parts and Accessories	6,525	6,700
Consumer Goods	14,252	12,954
Manufactured Consumer Nondurables	1,450	1,514
Cotton Apparel and Household Goods	112	71
Wool Apparel and Household Goods	40	29
Other Textile Apparel and Household Goods	163	123
Nontextile Apparel and Household Goods	43	84
Pharmaceutical Preparations	344	360
Printed Material	218	191
Manufactured Consumer Durables	12,642	11,370
Glassware and Chinaware	333	275
Cookware, Cutlery, House and Garden Wares and Tools	209	192
Household and Kitchen Appliances	625	418
Motorcycles and Parts	629	586
Pleasure Boats and Motors	447	213
Toys and Sporting Goods (incl. bicycles)	1,633	2,108
Photographic and Optical Equipment	952	772
Musical Instruments and Other Recreational Equipment	549	393
Television Sets and Other Video Equipment	2,810	3,230
Radios, Stereo Equipment and Other Audio Equipment	3,223	2,212
Jewelry and Watches	556	356
Artworks and Antiques	43	101
Unmanufactured Consumer Goods	161	70
Other Imports	985	1,061

Source: Department of Commerce

Table 51: U.S. Direct Investment Position Abroad, Yearend 1985-1989

(in millions of dollars)

	1985	1986	1987	1988	1989
Developed Countries	$172,058	$194,280	$237,508	$252,757	$279,310
Canada	46,909	50,629	57,783	62,610	66,856
United Kingdom	33,024	35,389	44,512	49,274	60,810
West Germany	16,764	20,932	24,388	21,742	23,059
Switzerland	15,766	16,441	19,665	18,357	19,952
Japan	9,235	11,472	15,684	17,927	19,341
Netherlands	7,129	11,643	14,842	16,017	17,168
France	7,643	8,952	11,868	13,150	14,747
Australia	8,772	9,340	11,363	13,186	14,495
Italy	5,906	7,426	9,264	9,540	10,634
Belgium	5,038	5,006	7,267	7,448	8,290
Ireland	3,693	4,308	5,425	6,212	6,237
Spain	2,281	2,707	4,076	4,979	6,002
Norway	3,215	3,216	3,843	4,371	3,640
Developing Countries	52,764	61,072	73,017	77,560	90,552
Bermuda	13,116	15,373	19,215	19,040	17,849
Brazil	8,893	9,268	10,951	12,460	14,687
Panama	3,959	5,525	6,622	6,632	7,906
Mexico	5,088	4,623	4,913	5,694	7,079
Hong Kong	3,295	3,912	4,389	5,244	5,853
Bahamas	3,795	2,991	3,814	4,010	4,463
Indonesia	4,475	3,217	3,070	2,925	3,696
Netherlands Antilles	-20,499	-16,969	-14,235	-11,633	-6,286
International	5,428	4,448	3,782	3,184	3,574
Total	230,250	259,800	314,307	333,501	373,436
of which:					
Petroleum	57,695	58,497	59,774	57,745	57,945
Manufacturing	94,700	105,101	131,645	139,584	155,704
Wholesale Trade	22,790	26,214	31,847	33,812	37,735
Banking	14,461	14,510	18,027	19,072	19,875
Finance, Insurance and Real Estate	22,501	36,414	53,046	60,477	77,112
Services	4,683	5,128	6,706	7,786	8,812
Other	13,421	13,935	13,262	15,025	16,253

Source: Department of Commerce

Table 52: U.S. Direct Investment Position in Japan, Yearend 1985-1989

(in millions of dollars)

	1985	1986	1987	1988	1989
Total	$9,235	$11,472	$15,684	$17,927	$19,341
Petroleum	2,184	2,712	2,642	3,356	3,194
Manufacturing	4,584	5,439	8,107	8,941	9,959
Food Products	128	157	371	334	286
Chemicals	1,311	1,591	2,159	2,423	2,508
Metals	82	130	175	186	186
Electric Machinery	331	475	744	1,070	1,177
Nonelectric Machinery	1,664	1,809	*	2,775	2,624
Transport Equipment	625	699	1,231	1,298	2,313
Other	443	579	*	854	866
Wholesale Trade	1,581	2,173	2,933	3,485	3,381
Banking	178	204	333	263	214
Finance, Insurance and Real Estate	520	686	1,231	1,291	1,981
Services	83	109	157	224	248
Other	104	149	281	366	363

*Suppressed to avoid disclosure of data on individual companies.

Source: Department of Commerce

Table 53: Foreign Direct Investment Position in the United States, Yearend 1985-1989

(in millions of dollars)

	1985	1986	1987	1988	1989
United Kingdom	$43,555	$55,935	$79,669	$101,909	$119,137
Japan	19,313	26,824	35,151	53,354	69,699
Netherlands	37,056	40,717	49,115	48,991	60,483
Canada	17,131	20,318	24,013	27,361	31,538
West Germany	14,816	17,250	20,315	23,845	28,223
Switzerland	10,568	12,058	14,686	15,896	19,329
France	6,670	7,709	10,119	11,364	16,375
Netherlands Antilles	10,443	9,685	9,317	10,591	10,570
Australia	3,264	5,466	6,015	5,330	6,236
Sweden	2,357	3,963	4,953	5,263	4,925
Belgium	2,291	2,487	2,638	4,024	4,535
Kuwait	3,968	3,771	3,919	3,852	4,197
OPEC Countries	4,607	4,787	4,897	6,221	7,462
Total	184,615	220,414	271,788	328,850	400,817
of which:					
Mining	4,039	5,080	5,718	6,390	7,179
Petroleum	28,270	29,094	35,598	34,704	35,089
Manufacturing	59,584	71,963	94,745	121,434	160,216
Wholesale Trade	29,051	33,997	39,754	50,160	54,549
Retail Trade	6,822	8,923	10,255	14,770	16,802
Banking	11,377	12,394	14,455	17,453	19,581
Finance	4,246	7,239	3,828	2,124	11,403
Insurance	11,806	15,345	17,392	20,252	22,713
Real Estate	19,402	22,512	27,516	31,929	38,853
Other	10,019	13,868	22,527	29,635	37,432

Source: Department of Commerce

Table 54: Japan's Foreign Direct Investment Position in the United States, Yearend 1985-1989

(in millions of dollars)

	1985	1986	1987	1988	1989
Total	$19,313	$26,824	$35,151	$53,354	$69,699
Mining	7	*	*	*	*
Petroleum	31	34	-2	-79	68
Manufacturing	2,738	3,578	5,345	12,222	17,255
Food Products	159	158	164	302	397
Chemicals	268	279	575	1,137	2,420
Metals	562	471	599	2,323	3,304
Machinery	715	1,052	1,527	2,542	4,960
Other	1,033	1,618	2,481	5,917	6,173
Wholesale Trade	11,796	13,687	15,352	18,390	20,486
Retail Trade	251	290	326	346	519
Banking	2,160	2,704	3,513	3,895	4,441
Finance	51	2,087	2,115	2,863	5,830
Insurance	119	*	*	*	*
Real Estate	1,536	2,941	6,098	10,017	14,294
Other	622	1,306	2,140	5,374	6,397

*Suppressed to avoid disclosure of data on individual companies.

Source: Department of Commerce

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JAPAN · ECONOMIC · INSTITUTE

JEI

REPORT

A Two-Part Report: A and B

NO. 36B
September 21, 1990

IN THIS ISSUE:

Japan's Middle East Commitments Scrutinized On Capitol Hill 1

Tokyo Debates Oil Product Pricing 3

Shevardnadze Visit Stirs Optimism About Future Japanese-Soviet Relations 5

Cabinet Official To Visit Beijing For Asian Games 7

Statistical Supplement 9

Japan's Middle East Commitments Scrutinized On Capitol Hill

Japan's September 14 announcement that it would increase its special assistance to the Middle East to approximately $4 billion came on the heels of escalating congressional criticism of the level of allied contributions to the U.S. military operation there. Tokyo initially had committed about $1 billion in logistical aid to multilateral forces opposing Iraq's invasion of Kuwait, with additional amounts to aid evacuees and Middle East nations, such as Jordan, Turkey and Egypt, adversely affected by the crisis (see JEI Report No. 35B, September 14, 1990). As Congress began to examine the costs of American initiatives in the Persian Gulf many legislators grew increasingly critical of apparent disparities in support from U.S. allies, particularly Japan and West Germany.

The most forceful sign of dissatisfaction with Japanese and West German initial contribution levels in the Middle East was seen in a 370-53 House vote during the debate on a $283 billion FY 1991 defense authorization bill. The September 12 vote was to adopt a burdensharing amendment introduced by Rep. David Bonior (D, Mich.) under which 5,000 U.S. troops a year would be withdrawn

Trade and Payments Data

(in millions of dollars unless otherwise indicated)

	1988	1989	January-June 1989	January-June 1990	April 1990	May 1990	June 1990
Japan's Balance of Payments							
Trade Balance	$95,012	$76,917	$41,105	$28,086*	$4,024*	$2,615*	$7,054*
Exports (f.o.b.)	259,765	269,570	133,505	130,844*	21,175*	21,103*	23,106*
Imports (f.o.b.)	164,753	192,653	92,400	102,758*	17,151*	18,488*	16,052*
Current Account Balance	79,631	57,157	30,347	20,550*	2,002*	1,461*	4,782*
Long-Term Capital (net)	-130,930	-89,246	-36,413	-34,807*	-5,343*	-5,557*	-7,821*
Overall Balance	-28,982	-33,286	-2,926	-8,003	-19,836	8,891	3,008
International Reserves (end of period)	97,662	84,895	89,462	73,649	73,024	73,557	73,649
Japan's Customs Clearance Trade							
Trade Balance	77,563	64,328	33,394	25,760	3,543	3,108	6,693
Exports (f.o.b.)	264,917	275,175	135,829	133,962	21,916	21,546	23,782
Cars	38,671	38,804	19,804	19,759	2,987	2,958	3,269
Steel	15,322	14,789	7,598	5,882	987	980	1,003
Imports (c.i.f.)	187,354	210,847	102,435	108,202	18,373	18,438	17,088
Crude Oil	18,852	21,544	10,273	12,375	2,204	1,708	1,546
Manufactured Products	91,838	106,111	51,058	55,180	9,608	9,394	8,949
Japan-U.S. Trade							
Trade Balance	47,597	44,943	22,060	17,032	2,451	2,421	3,224
Exports (f.o.b.)	89,634	93,189	45,724	42,602	6,734	6,812	7,393
Imports (c.i.f.)	42,037	48,246	23,663	25,570	4,283	4,390	4,169
Yen-Dollar Exchange Rate (average for period)	Y128.15	Y137.96	Y133.26	Y151.58	Y158.47	Y153.52	Y153.77
U.S. Trade							
Trade Balance	-118,526	-109,399	-49,592	-41,111*	-6,112	-6,925	5,925*
Exports (f.a.s.)	322,426	363,812	183,079	198,180*	32,600	33,678	34,530*
Imports (Customs)	440,952	473,211	232,671	239,291*	38,712	40,603	40,455*
U.S.-Japan Trade							
Trade Balance	-51,793	-49,059	-24,424	-19,589*	-3,952	-2,966	-3,069*
Exports (f.a.s.)	37,725	44,494	21,847	23,484*	3,603	3,736	4,182*
Imports (Customs)	89,518	93,553	46,271	43,073*	7,555	6,702	7,251*

*Preliminary

Japanese Economic Indicators

(percent change from year-earlier period unless otherwise indicated)

	1988	1989	January-June 1989	January-June 1990	April 1990	May 1990	June 1990
Discount Rate (end of period)	2.5%	4.25%	3.25%	5.25%	5.25%	5.25%	5.25%
Outstanding Money Supply	11.2%	9.9%	10.0%	12.3%	13.2%	13.2%	12.6%
Industrial Production	9.5%	6.1%	7.8%	2.6%	3.1%	4.3%	3.0%
Manufacturing Operating Rate	5.9%	2.2%	3.6%	0.8%	1.4%	3.0%	-0.3%
Number of Bankruptcies	-20.0%	-28.4%	-26.2%	-25.5%	-22.4%	-24.1%	-18.7%
Residential Construction Starts	0.6%	-1.3%	-2.5%	4.3%	0.5%	8.4%	7.8%
Job Openings to Applications (ratio)	1.01	1.26	1.21	1.38	1.34	1.41	1.47
Nominal Wages	3.8%	4.7%	4.6%	5.3%	4.5%	5.1%	7.3%
Manufacturing Labor Productivity	11.5%	6.2%	10.1%*	2.2%*	n.a.	n.a.	n.a.
Wholesale Prices	-1.0%	2.5%	1.7%	2.7%	2.7%	1.7%	0.9%
Consumer Prices	0.7%	2.3%	1.9%	2.9%	2.5%	2.7%	2.2%
Yen-Based Export Prices	-2.2%	4.4%	4.1%	6.0%	9.1%	5.4%	2.3%
Yen-Based Import Prices	-4.6%	7.7%	5.0%	10.2%	13.3%	7.0%	3.0%

*Through March of each year only.

For Japan's latest GNP figures, see JEI Report No. 13B, March 30, 1990.

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JAPAN · ECONOMIC · INSTITUTE
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REPORT

A Two-Part Report: A and B

NO. 37A

September 28, 1990

1990 UPDATE ON JAPANESE RESEARCH AND DEVELOPMENT

Summary

From an overall viewpoint the course of Japanese research and development activities remains rock steady: total spending continues to rise healthily and spending patterns show little change. Closer examination, however, shows that Japanese R&D is responding, albeit gradually, to the country's new responsibilities as the world's second-largest economy. "Internationalization" of Japanese R&D will not be an easy process either for Japanese managers, who must alter their way of doing things, or for foreigners, concerned with Japan's competitive challenge and suspicious of ulterior Japanese motives. Nevertheless, the process has begun and could have a profound global impact in the long run.

Overview

Throughout the 1980s Japanese corporate executives and government leaders gradually realized that the nation's research and development capabilities were on par with those of the United States and European countries. After decades of tutelage in foreign science Japan's steady efforts to build a solid technology base elevated it to a peer position with its former teachers. For the Japanese, who arrange all things in strict hierarchies (very few things are truly "equal" in their minds), this shift in status may take years before being fully accepted. Because of the nation's new economic might, however, foreigners want Japan to go beyond simple equality in the research field and are urging it to assume the role of teacher in some areas. Many Japanese agree that sharing technology is one way their country can play a positive leading role in the international community. Others view technology-sharing as a way to pay the debt

Japan owes foreigners who openly shared their scientific and technological resources when, as a war-ravaged nation, it sought to rebuild. Whatever the reason, Japanese R&D policy now must address several goals rather than the previous single goal of catching up with the West. The challenge is more than simply boosting spending; Japan will need to reorder priorities and assume new roles.

Aggregate statistics - According to the latest government survey, total R&D spending in Japan rose 8 percent to Y10,627.6 billion ($70.9 billion at Y150=$1.00) in the 12-month period ending March 31, 1989 (see Table 1a). Although this represents a faster growth rate than the previous two years, it still is below the double-digit performances logged in FY 1983 and FY 1985. Data arranged by spending organization shows the corporate sector in the lead with an 11.2 percent gain to just over Y7.2 trillion ($48 billion), overshadowing the much weaker performances by universities -- up 2.9 percent to barely more than Y2 trillion ($13.3 billion) -- and research institutions, which registered a tiny 0.7 percent increase to just under Y1.4 trillion ($9.3 billion). By virtue of their strong performance companies expanded their share of total R&D spending to just under 68 percent.

The private sector also led the way when the data are presented according to funding source (Table 1b). While the business community's 10.2 percent expansion was significant in its own right (although not spectacular given the 12 to 14 percent gains registered in the early 1980s), the stagnation of government-financed R&D was the real story. Public R&D funds grew a mere 0.3 percent in FY 1988, dropping the government's share of total R&D funding to less than one-fifth for the first time since this type of statistic was released. Until FY 1988 the R&D budget had managed to escape the Ministry of Finance's fiscal austerity axe. If the growth of government spending does not return to robust health, Tokyo's commitment to becoming a technology source for the world surely will be questioned.

Data on Japanese R&D by purpose also cast doubt on Japan's willingness to become a source of basic research knowledge. Money for developmental work, which leads directly to commercial products, took a bigger share of total R&D spending in FY 1988, while the portion allotted to basic research edged back (see Table 2). Those fairly consistent percentages followed a six-year pattern that indicates that commercial technology remains Japan's top R&D priority.

Data broken down by purpose by spending organization underscore both of the above trends (see Table 3). The breakdown of corporate work among basic, precommercial and commercial research was unchanged in FY 1988. (This implies, however, that basic research by companies grew 11.2 percent, the same rate of increase as overall company spending.) Basic research outlays by both universities and research institutions were down as a percentage of total spending. The slight decline in basic research undertaken by universities was ominous since university work, which is subject to the whims of bureaucrats and politicians, constitutes the bulk of basic research in Japan.

Government Spending - Faced with ballooning interest payments on the national debt, fiscal austerity has been Tokyo's watchword on spending since

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the early 1980s (see JEI Report No. 26A, July 7, 1990). To balance the budget the Ministry of Finance has tried to enforce on other ministries a policy of zero growth for capital expenditures (such as public works and other infrastructure) and cuts in current outlays (including administrative costs and wages). The government was able to keep a lid on new spending through the mid-1980s, but its grip began to slip at the end of the decade. The importance Tokyo attaches to R&D clearly is more than rhetorical; Table 4 shows that the growth of research outlays outpaced the expansion of both total and discretionary spending during most of the years of strictest austerity. The data also show, however, that R&D spending is not sacrosanct. In recent years in particular R&D outlays have not kept up with overall or discretionary spending.

When government spending is broken down by ministry for the latest two fiscal years (see Tables 5 and 6), the goals of Tokyo's R&D policies become obscured by a confusing pattern of changes in annual outlays. Some agencies, the Labor Ministry for example, post big gains one year but suffer cuts the next. Ministries that might be expected to have a strong claim to government R&D funds show surprisingly weak gains, such as the Ministry of Posts and Telecommunications. Nevertheless, some insights can be drawn from the data. Ministries with the greatest responsibility for R&D policy -- the Ministries of Education and International Trade and Industry plus the Science and Technology Agency -- naturally account for the largest allocations and show the most dependable growth. Some specific priorities also are clear. Defense-related R&D outlays have grown strongly and steadily over the past several years. In addition, the jump in FY 1990 funding for the Environment Agency may signal a long-term commitment in this field.

A better idea of each agency's thinking can be gleaned from a detailed look at FY 1990 spending plans (see Table 7). Nuclear power is high on the list of several agencies, including STA, MITI and the Foreign Ministry. Promoting new technologies -- STA's Space Development Association and New Technology Development Association, MITI's large-scale industrial technology program and the Ministry of Transportation's magnetic levitation research, for example -- remains a salient feature of spending. Fairly new to the list are programs aimed at basic research, including MITI's Human Frontiers Science Program and the Basic Technology Promotion Center (a joint venture of MITI and the Ministry of Posts and Telecommunications). Environmental issues also are gaining attention, with most ministries launching programs in this area (albeit often very small ones). The Environment Agency has rededicated its former disaster prevention institutes to the study of global environmental issues. MITI's Global Environment Industrial Technology Institute, moreover, is expected to have an even larger budget in FY 1991.

Tokyo is clearly sticking with policies that have helped foster the nation's technology successes -- policies that focus on developing precommercial know-how. New wrinkles are appearing in the form of greater support for basic and international research ("international" in that it either involves foreign participation or is aimed at global issues). How well these new categories fare in future budget negotiations will be one indicator of Tokyo's commitment to playing a larger global role.

Private Spending - The data in Table 1 make it clear that while government spending is nothing to ignore, the real R&D action in Japan happens in the private sector. Companies outspent the government four-to-one in FY 1988, a ratio that probably has tipped even more toward the private sector's favor since then, if reports of double-digit business spending growth are true. Intense competition -- both domestic and foreign -- has forced Japanese companies to adopt a strong technology development program as a key element of their business strategies. While not completely immune to corporate planners' profitability scales, R&D budgets have been spared the full blow of the cost cutter's axe during slow business periods because many managers see R&D as crucial to their firm's future competitiveness. They and others attribute record corporate profits during the late 1980s, at least in part, to vigorous R&D spending in previous years. These record profits, in turn, have led to even larger R&D budgets, which are expected to further strengthen the competitive position of Japanese firms in the 1990s.

The latest government data on private R&D extend only through FY 1988 (see Table 8). Nevertheless, the upsurge in research activity in the business sector is clear from the near-doubling of the growth of spending in FY 1988. Only two industries recorded declines that year compared with seven the year before. Fourteen areas showed double-digit growth rates in FY 1988 compared with 10 in the previous period. Agriculture's string of big increases was notable, as was the rebound in research spending by the mining and the motor vehicle industries.

The commitment of Japanese management to R&D is obvious when it is expressed as a share of gross sales (see Table 9). Only one sector, agriculture, recorded a lower R&D-to-gross sales ratio in FY 1988 than in FY 1978; even then, agriculture's ratio had been on the rise since FY 1983. While a handful of industries showed only modest improvement in this ratio, many raised their figures by 50 to 100 percent. This was particularly true for "low technology" industries, such as textiles, food products and publishing. At the other end of the scale outlays by the pharmaceuticals, electronics and precision machinery industries led the pack.

Since private R&D is at the cutting edge in many fields, it is not surprising that Japanese corporations feel pressure similar to that put on Tokyo to share their know-how with the rest of the world. Japanese companies are faced with two demands: increase funding for basic research (which is to be freely shared) and transfer more technology to foreign partners. As mentioned earlier, the business sector did not change the way it split R&D outlays among basic, applied and developmental research between FY 1987 and FY 1988. The situation was far from static, however. Table 10 shows that while the overall figures did not change, the allocations by individual industries underwent small but definite shifts. Again, it is unsurprising to find that the petroleum and coal products industry and the chemical industry (pharmaceuticals, in particular) devote a relatively high proportion of their R&D budgets to basic research. One interesting development was the sharp increase in basic research by the mining industry, although the reasons for this reallocation were not clear.

Technology Trade - Perhaps one of the most aggravating Western stereotypes of Japanese companies is that they scavenge the globe for useful technologies but jealously horde domestically developed know-how. Most of Japan's biggest export items -- motor vehicles and industrial or consumer electronics -- were invented overseas. By licensing or copying (or, some would charge, stealing) basic technologies and adding domestic innovations in product and process technologies, Japanese firms rapidly rebuilt their industrial competitiveness. Foreign countries now feel that Japan somehow "owes" the rest of the world for its commercial success and the economic dislocations that success has caused overseas.

The latest government data on technology flows indicate, however, that Japan has not fully come to terms with this perception. Imports of technology in FY 1988 still surpassed exports in both the number of transactions and their total value (see Tables 11 and 12). Although the gap is narrower for new technology transactions (excluding payments or renewals of previous deals), the lack of an export trend is not encouraging for Japan's reputation. The picture becomes more troublesome when the data are broken down by industry (see Table 13). The manufacturing sector naturally accounts for the bulk of activity, but the gap between technology imports and exports by this sector as a whole widened between FY 1987 and FY 1988, particularly in terms of the number of transactions.

When technology trade is analyzed by country (see Table 14), the picture is only slightly more encouraging. Exports of Japanese technology to Asian nations, the United States and Western Europe generally exhibited good gains between FY 1985 and FY 1988. Imports of technology, however, particularly from the United States, turned in an even stronger performance. This translated into a widening technology deficit for Japan with its major technological competitors, which also happen to be its major trading partners. It is also clear that Japan is not focusing much attention on developing nations outside of Asia. These two points spell trouble for Japan's efforts to play a global role commensurate with its economic might.

Internationalization of Japanese R&D

Paralleling Japan's rise to the status of economic superpower has been the growing debate, both in Japan and abroad, over the country's new international responsibilities. "Globalization" and "internationalization" have become buzzwords in the Japanese lexicon but are vaguely defined. As they apply to Japanese R&D policy, however, the words take on a more concrete meaning. Globalization of Japanese R&D means establishing ties to foreign research resources and building a research presence overseas. Internationalization carries the process one step further by diffusing Japanese technology to foreigners through the promotion of foreign research activities in Japan, dissemination of Japanese research more widely and elimination of the distinctions between Japanese and foreign research activities. Globalization of Japanese R&D is well along. Internationalization, however, is just beginning. Not only are Japanese companies and public research organizations having difficulty implementing this idea, but foreigners are greeting Japanese initiatives with more than a touch of suspicion.

Government Efforts - Bilateral cooperation pacts have been a staple of Japan's research policy. Japanese researchers have been welcomed at U.S. government research facilities for many years, particularly at the National Institutes of Health. In addition, Washington and Tokyo have cooperated on many projects in the energy field, including nuclear power and alternative energy sources. Technology cooperation in defense was formalized by a November 1983 exchange of diplomatic notes but has yet to induce a significant flow of technology from Japan. In fact, the 1988-89 flap over Japan's FSX fighter aircraft program (see JEI Report No. 21A, May 26, 1989) has soured the atmosphere for bilateral transfers of military technology, at least temporarily. Cooperation in the scientific and civilian aerospace fields has been smoother. Japan's participation in the U.S. program for a permanently manned space station is an important element in the overall operational scheme. Moreover, a Japanese astronaut has a reservation aboard the U.S. space shuttle for sometime next year. Tokyo's cooperative research pacts with many European countries and the extension of technological assistance to many developing countries indicate that the globalization of Japanese government R&D is firmly under way.

Tokyo's first attempt at internationalizing government-funded R&D came in 1986 when then Prime Minister Yasuhiro Nakasone announced a 20-year international project to explore basic biological functions. The Human Frontiers Science Program was a unique proposal: Tokyo would provide up to half of the projected Y1 trillion ($6.7 billion) cost; moreover, foreign researchers would not simply participate in the research but would direct certain portions as well. Unaccompanied by details, the plan was slow to take shape. When Tokyo began filling in the blanks, however, it ran into a great deal of resistance from foreign research institutes and governments suspicious of the unprecedented nature of Japan's offer. Only after Tokyo agreed to establish an independent foundation in Strasbourg, France to administer the program were foreigners more forthcoming. Even then Tokyo's failure until FY 1989 to appropriate significant funds for the new program continued to feed foreign doubts.

More than four years after the project was announced the HFSP foundation has received 239 applications for research grants, 202 applications for long-term fellowships, 11 requests for short-term fellowships and 36 proposals for workshops. Summary information on the successful applicants is presented in Table 15. Foreign researchers are receiving the majority of support, accounting for 77.5 percent of the long-term fellowships, 70 percent of the research grants and 65 percent of the research grant funds. Foreign countries also are benefiting: 45 of the 80 long-term fellowships will be conducted in the United States, eight each in West Germany and Canada, seven in France, five in Britain and just four in Japan. MITI plans to spend more than Y1.3 billion ($8.7 million) on HFSP in FY 1990 and has requested a little under Y1.7 billion ($11.3 million) for the upcoming fiscal year. After a rocky start HFSP seems to be off on the right foot.

Tokyo's next move was to open existing or planned government-industry research consortia to foreign firms. During FY 1989 at least eight foreign firms (often via their Japanese subsidiaries) joined new public-private research projects, an approach credited as key to Japan's rapid development of technology. International Business Machines Corp. and Thomson CFS of France are charter members of the International Fuzzy Engineering Institute, which is developing computers that can handle ambiguous inputs or data. General Electric Co. and the Pratt & Whitney division of United Technologies Corp. agreed in 1989 to join a MITI consortium developing a jet engine for a Mach 5 aircraft. Other consortia that have attracted foreign interest are aimed at developing advanced electric/electronic appliances, nonlinear optical materials, biodegradable plastics and next-generation composite materials. Japanese officials are disappointed that foreign firms have not been more aggressive in taking advantage of this open-door policy. Foreign firms grumble that some of the critical projects, such as X-ray lithography, are closed to them or that participation is too expensive.

Tokyo's newest international initiative is the Intelligent Manufacturing System. First proposed in late 1989 by the Ministry of International Trade and Industry, IMS is envisioned as "an advanced production system which, through interface of man and intelligent machinery, integrates the entire manufacturing process from order through design, production and distribution." MITI, in essence, is proposing a single computer standard that would replace standards that have been developed independently to handle various stages of production (for example, Electronic Data Interchange for order handling, General Motors Corp.'s Manufacturing Automation Protocol and Boeing Co.'s Technical and Office Protocol). MITI originally was willing to put up two-thirds of the 10-year project's estimated Y150 billion ($1 billion) price tag and submitted the proposal to all 24 members of the Organization for Economic Cooperation and Development. After signing up 64 Japanese firms to participate (not without some difficulty), MITI established the IMS Promotion Center, which includes foreign firms (United Technologies and Rockwell International Corp., for example), to manage the project. The Society of Mechanical Engineers, a Michigan-based trade association, was picked in May to promote the project in North America.

Although American and European firms see some potential gains from the project (if it is managed correctly), the IMS proposal set off alarm bells in Washington and Brussels, the headquarters of the European Community. U.S. and EC officials publicly charged that the plan was nothing more than a ruse to erase the American and the European leads in some areas and to establish Japanese dominance in manufacturing technologies. Both Washington and Brussels insisted that the project be handled at the government-to-government level, a move Tokyo initially resisted. The United States and the EC also demanded that the cost of the project be born equally by the three partners and that they be allowed to submit their own ideas about program goals and structure. The Department of Commerce claimed negotiating authority under the 1988 U.S.-Japan Science and Technology Agreement and set late September initial public discussions with U.S. industry. Industry opinions will be incorporated into departmental proposals to be presented to Japan and the EC at a meeting this fall.

MITI officials are frustrated by foreign reactions to their first attempts to internationalize Japan's research efforts. "Damned if you don't and damned if you do" aptly sums up their feelings. To be sure, foreigners do have some legitimate complaints about Japan's approach. Important issues, such as intellectual property rights, often are neglected or clumsily handled. Nevertheless, Japan's experience so far underscores the sensitivity and the importance of the internationalization effort. It is unlikely that Tokyo will back off from the task, but it may be more careful about how it structures and implements future initiatives.

Private Efforts - The high level of private-sector R&D spending in Japan is attracting increased attention from foreign governments and companies. Many Americans argue, for example, that bilateral technology flows will remain heavily in Japan's favor until Japanese companies open their research programs to foreigners in the same way that American universities and research institutes open their doors to Japanese. Understandably, such opinions gall Japanese firms that deem their technological prowess to be due more to their own hard work than anything learned from abroad. Nevertheless, political and business realities are forcing Japanese firms to globalize and internationalize their R&D.

According to a major Japanese electronics firm, corporate globalization has clearly defined stages: globalization of markets (exports), followed by globalization of production (overseas factories), then globalization of corporate finance (raising and investing funds in overseas markets) and, finally, globalization of technology (conducting research abroad). Beginning in the 1970s Japanese firms began opening small R&D centers overseas for one of two reasons: to monitor local technology developments and transfer the information back to Japan (vertical technology transfers) or to tailor products to meet local needs (horizontal technology transfers). The success of Japanese cars and some consumer electronics products in the U.S. market can be attributed in part to the American design centers established by Japanese firms.

Globalization of corporate technology is the next step and can take several forms. Many Japanese automotive makers are upgrading their American design offices to handle the task of developing new models from the ground up. While technical information is passed back and forth between the American engineering teams and their Japanese counterparts, the foreign engineering operation is expected to become highly autonomous. In some cases the upgraded overseas research facility becomes fully integrated into the domestic research program, thus allowing foreigners to become "insiders" without traveling to Japan. Other Japanese companies, such as NEC Corp., have founded research centers in the United States modeled after the traditional research institute that focuses on basic research in an open academic environment. Although there usually are a few Japanese company scientists pursuing research at these new institutes, the majority of openings are offered to local scientists. Still other companies are opening research facilities targeted at a specific market. For example, Matsushita Electric Industrial Co., Ltd., Sony Corp. and Toshiba Corp. all have opened U.S. laboratories to develop high-definition television technology.

According to a 1990 Science and Technology Agency survey, 89 Japanese firms capitalized at more that Y1 billion ($6.7 million) have established 188 R&D centers employing 4,300 people worldwide. North America is the home of more than 80 percent of these centers, far ahead of Europe (11 percent) and Asia (4 percent). Respondents gave the following reasons for setting up overseas R&D facilities: to develop technologies tailored to offshore markets (59.6 percent), to globalize business activities (34.6 percent), to enhance the technological levels of foreign factories (29.4 percent), to promote research ties to universities and train personnel (23.5 percent) and to attract talented local employees (21.5 percent). Globalization and internationalization have yet to become firmly rooted in the minds of Japanese management, however. Of the 833 companies surveyed, only 17 percent said they had or would set up overseas R&D facilities; 53 percent were undecided and 30 percent said they no intention of doing so.

Globalization also affects domestic research efforts. Japanese companies are opening their research facilities at home to foreigners, if slowly. Hitachi, Ltd. (35 positions), NEC (26 openings) and Nippon Telegraph and Telephone Corp. (50 fellowships) include foreign scientists on the staff of some of their top research laboratories. Foreign critics point out, however, that such programs remain minute in comparison to Japanese access to foreign research facilities.

The skyrocketing cost of R&D in some fields is forcing Japanese firms to find foreign partners to share the risks. Hitachi and Texas Instruments Inc. penned an accord in 1988 to jointly develop the next generation of memory chips. American Telephone & Telegraph Co. struck a similar agreement this year with Mitsubishi Electric Corp. IBM has agreed with various Japanese firms to develop computer components, such as high-performance liquid crystal displays. The Electronic Industries Association of Japan and the Semiconductor Industry Association have hammered out a project to jointly develop electronic components for advanced televisions.

In other cases Japanese and foreign firms have entered into joint research agreements to compensate for each other's weaknesses. Motorola Inc. and Toshiba, for example, are exchanging microprocessor (Motorola) and memory (Toshiba) technologies. NEC and AT&T have a similar agreement covering design technology for application-specific integrated circuits.

Japanese firms also are trading their technological expertise for a foothold in foreign markets. Japanese steelmakers, for example, have provided technology to vertically integrated American steel companies through joint ventures. In Brazil, where foreign investment is restricted, Japanese companies hoping to do business usually must find a joint venture partner and transfer the relevant know-how; this is a pattern common to Japanese companies' dealings with many developing countries.

Despite all this activity Japanese companies remain under pressure from abroad and at home to do more. Some Japanese scholars suggest that one way to reduce the country's trade surplus is for Japanese firms to transfer product and process technologies abroad rather than export final goods. U.S. officials want Japanese firms to transfer more technology that has military applications as well as civilian uses, but this remains a highly sensitive topic. Japanese companies are struggling to find the right balance between sharing with the world the fruits of their massive R&D programs and retaining a proprietary hold on key technologies.

Conclusion

Japan's R&D machine clearly is well fed, productive and growing stronger. Its products match -- and, in some areas, surpass -- the best that the United States or Europe has to offer. Japanese business and government leaders have good reason to take pride in the rapid development of such a powerful technology base after World War II's decimation of the economy. As Japan has changed, however, so has the global environment. Japanese companies understand that they no longer can be only technology buyers in the global arena but must become technology suppliers as well. Contributing to the world's supply of knowledge also could be more than just good business for Japan: It is one way to respond to international criticism that Japan has little sense of its global role or responsibilities. As Tokyo's experiences with the Human Frontiers Science Program and the Intelligent Manufacturing System project show, however, overcoming foreign suspicions is not a simple task.

Nevertheless, both the Japanese government and the private sector have added new priorities to their R&D programs and have begun altering behavior patterns. Greater contributions to basic science as well as better dissemination of Japanese technology abroad surely will be long-term products of the changes now under way. At the same time, however, the process of restructuring Japan's R&D machine no doubt will be slow and will demand difficult adjustments by both Japanese and foreigners alike.

For further information, contact Jon Choy.

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The views expressed in this report are those of the author and do not necessarily represent those of the Japan Economic Institute.

Table 1: Japan's R&D Expenditures, FY 1983-FY 1988

(in billions of yen and percent)

a. By Spending Organization

Fiscal Year	Companies	Research Institutions	Universities	Total
1983	Y4,560.1	Y971.0	Y1,649.6	Y7,180.8
Change	12.9%	2.3%	7.1%	10.0%
Share	63.5%	13.5%	23.0%	100.0%
1984	5,136.6	1,033.1	1,724.2	7,893.9
Change	12.6%	6.4%	4.5%	9.9%
Share	65.1%	13.1%	21.8%	100.0%
1985	5,939.9	1,160.6	1,789.8	8,890.3
Change	15.6%	12.3%	3.8%	12.6%
Share	66.8%	13.1%	20.1%	100.0%
1986	6,120.2	1,240.2	1,832.6	9,192.9
Change	3.0%	6.9%	2.4%	3.4%
Share	66.6%	13.5%	19.9%	100.0%
1987	6,494.3	1,384.5	1,957.9	9,836.6
Change	6.1%	11.6%	6.8%	7.0%
Share	66.0%	14.1%	19.9%	100.0%
1988	7,219.3	1,394.2	2,014.1	10,627.6
Change	11.2%	0.7%	2.9%	8.0%
Share	67.9%	13.1%	19.0%	100.0%

b. By Source of Funds

Fiscal Year	Government	Private	Foreign	Total
1983	Y1,721.4	Y5,451.1	Y8.2	Y7,180.8
Change	3.3%	12.3%	17.1%	10.0%
Share	24.0%	75.9%	0.1%	100.0%
1984	1,777.8	6,108.6	7.6	7,893.9
Change	3.2%	12.1%	-7.3%	9.9%
Share	22.5%	77.4%	0.1%	100.0%
1985	1,867.3	7,014.9	8.1	8,890.3
Change	5.0%	14.8%	6.6%	12.6%
Share	21.0%	78.9%	0.1%	100.0%
1986	1,955.3	7,229.7	7.9	9,192.9
Change	4.7%	3.1%	-2.5%	3.4%
Share	21.5%	78.4%	0.1%	100.0%
1987	2,111.8	7,716.6	8.2	9,836.6
Change	8.0%	6.7%	3.8%	7.0%
Share	21.5%	78.4%	0.1%	100.0%
1988	2,117.8	8,501.5	8.3	10,627.6
Change	0.3%	10.2%	1.2%	8.0%
Share	19.9%	80.0%	0.1%	100.0%

Source: Management and Coordination Agency, Report on the Survey of Research and Development.

Table 2: Japan's Research Expenditures by Purpose, FY 1983-FY 1988

(in billions of yen and percentage share)

Fiscal Year	Basic Research	Applied Research	Developmental Research
1983	Y896.7	Y1,630.1	Y3,882.8
	14.0%	25.4%	60.6%
1984	959.9	1,780.8	4,340.2
	13.6%	25.1%	61.3%
1985	1,030.6	2,001.8	4,985.9
	12.9%	25.0%	62.2%
1986	1,102.8	2,030.8	5,185.0
	13.3%	24.4%	62.3%
1987	1,250.2	2,166.8	5,497.3
	14.0%	24.3%	61.7%
1988	1,288.0	2,346.6	6,041.0
	13.3%	24.3%	62.4%

Source: Management and Coordination Agency, Report on the Survey of Research and Development.

Table 3: Japan's Research Expenditures by Spending Organization by Purpose, FY 1983-FY 1988

(share of each organization's total expenditures in percent)

Fiscal Year	Basic Research	Applied Research	Developmental Research
1983			
Universities	57.4%	35.0%	7.6%
Research Institutions	13.2	33.2	53.6
Companies	5.2	21.8	73.0
1984			
Universities	54.9	36.9	8.3
Research Institutions	12.6	30.9	56.5
Companies	5.7	22.0	72.3
1985			
Universities	54.2	37.4	8.4
Research Institutions	12.3	30.0	57.7
Companies	5.9	21.9	72.1
1986			
Universities	54.2	37.4	8.4
Research Institutions	13.8	27.4	58.8
Companies	6.1	21.6	72.3
1987			
Universities	54.2	37.4	8.4
Research Institutions	15.8	26.0	58.2
Companies	6.6	21.7	71.7
1988			
Universities	52.8	38.5	8.7
Research Institutions	14.9	25.4	59.7
Companies	6.6	21.7	71.7

Source: Management and Coordination Agency, Report on the Survey of Research and Development.

Table 4: Japanese Government Research Expenditures as a Share of the General Account Budget, FY 1982-FY 1990

(revised budgets in billions of yen and percent)

a. As a Share of Total Expenditures

Fiscal Year	Total Expenditures	Research Expenditures	Share
1982	Y47,562.1	Y1,448.0	3.0%
1983	50,839.4	1,448.9	2.8
1984	51,513.4	1,477.6	2.9
1985	53,222.9	1,521.6	2.9
1986	53,824.8	1,599.0	2.9
1987	58,241.2	1,655.0	2.8
1988	61,851.7	1,715.7	2.8
1989	66,311.9	1,814.8	2.7
1990*	66,236.8	1,919.6	2.9

b. As a Share of Discretionary Expenditures

Fiscal Year	Total Expenditures	Research Expenditures	Share
1982	Y33,120.0	Y1,448.0	4.4%
1983	35,356.8	1,448.9	4.1
1984	33,244.5	1,477.6	4.4
1985	33,352.3	1,521.6	4.6
1986	33,425.7	1,599.0	4.8
1987	35,276.5	1,655.0	4.7
1988	36,789.8	1,715.7	4.6
1989	39,257.4	1,814.8	4.6
1990*	36,673.1	1,919.6	5.2

*Initial budget.

Source: Ministry of Finance

Table 5: Japanese Government R&D Expenditures, FY 1989

(in millions of yen and percentage change)

	Science Promotion	Energy and Other Research	Special Research	Total
Diet	Y533	Y0	Y0	Y533
	3.0%	--	--	3.0%
Japan Technology Council	0	867	0	867
	--	-4.0%	--	-4.0%
Police Agency	1,020	0	0	1,020
	4.9%	--	--	4.9%
Hokkaido Development Agency	147	0	0	147
	3.1%	--	--	3.1%
Defense Agency	0	93,068	0	93,068
	--	12.5%	--	12.5%
Economic Planning Agency	764	0	0	764
	6.7%	--	--	6.7%
Science and Technology Agency	189,400	166,043	111,181	466,623
	10.8%	-2.0%	11.4%	6.0%
Environment Agency	7,882	0	0	7,882
	1.7%	--	--	1.7%
Justice Ministry	871	0	0	871
	2.6%	--	--	2.6%
Foreign Ministry	0	6,408	0	6,408
	--	-0.1%	--	-0.1%
Finance Ministry	348	0	738	1,087
	3.3%	--	15.2%	11.1%
Education Ministry	68,439	128,366	657,517	854,322
	7.3%	0.7%	5.7%	5.1%
Health Ministry	36,371	1,161	10,838	48,370
	12.5%	2.9%	2.1%	9.8%
Agriculture Ministry	62,350	1,929	3,400	67,679
	1.9%	4.5%	-5.6%	1.6%
International Trade and Industry Ministry	55,799	13,628	164,213	233,640
	2.1%	-0.7%	7.4%	5.6%
Transportation Ministry	13,255	2,162	913	16,300
	6.4%	73.0%	-0.3%	11.4%
Posts and Telecommunications Ministry	4,341	105	26,000	30,447
	4.1%	-6.8%	0.0%	0.5%
Labor Ministry	612	1	3,945	4,557
	1.8%	0.0%	27.0%	22.9%
Construction Ministry	5,376	313	0	5,689
	3.3%	23.3%	--	4.2%
Home Affairs Ministry	555	0	0	555
	2.2%	--	--	2.2%
Total	448,032	414,049	952,745	1,814,827
	7.4%	2.2%	6.7%	5.8%

Source: Science and Technology Agency

Table 6: Japanese Government R&D Expenditures, Planned FY 1990

(in millions of yen and percentage change)

	Science Promotion	Energy and Other Research	Special Research	Total
Diet	Y533 0.0%	Y0 --	Y0 --	Y533 0.0%
Japan Technology Council	0 --	951 9.7%	0 --	951 9.7%
Police Agency	1,055 3.4%	0 --	0 --	1,055 3.4%
Hokkaido Development Agency	149 1.4%	0 --	0 --	149 1.4%
Defense Agency	0 --	104,268 12.0%	0 --	104,268 12.0%
Economic Planning Agency	809 5.8%	0 --	0 --	809 5.8%
Science and Technology Agency	204,905 8.2%	164,933 -0.7%	124,937 12.4%	494,775 6.0%
Environment Agency	9,217 16.9%	0 --	0 --	9,217 16.9%
Justice Ministry	939 7.8%	0 --	0 --	939 7.8%
Foreign Ministry	0 --	7,095 10.7%	0 --	7,095 10.7%
Finance Ministry	358 2.7%	0 --	730 -1.1%	1,087 0.1%
Education Ministry	74,637 9.1%	129,907 1.2%	689,721 4.9%	894,301 4.7%
Health Ministry	38,831 6.8%	1,319 13.5%	10,092 2.3%	51,242 5.9%
Agriculture Ministry	64,164 2.9%	2,544 11.2%	3,300 -2.9%	70,007 2.9%
International Trade and Industry Ministry	55,580 -0.4%	12,912 -5.3%	181,340 10.4%	249,832 6.9%
Transportation Ministry	13,060 -1.2%	3,311 53.2%	1,039 13.3%	17,410 6.8%
Posts and Telecommunications Ministry	4,468 2.9%	189 79.8%	26,543 0.5%	31,199 1.1%
Labor Ministry	630 3.0%	38 5,483.6%	3,522 -11.0%	4,190 -8.1%
Construction Ministry	5,525 2.8%	454 45.3%	0 --	5,979 5.1%
Home Affairs Ministry	565 1.8%	0 --	0 --	565 1.8%
Total	475,460 6.1%	427,921 3.3%	1,016,222 6.6%	1,919,603 5.7%

Source: Japan Society for the Promotion of Science, Japanese Scientific Monthly, July 1990.

Table 7: Expenditures on Selected Science Programs by Agency, FY 1989-FY 1990

(in millions of yen)

	FY 1989	FY 1990
Japan Defense Agency		
Technology development	Y92,068	Y104,268
Science and Technology Agency		
Agency research (including four air and space development organizations)	31,753	34,008
Physical Chemistry Research Institute	16,056	17,110
New Technology Development Association	1,850	1,775
Science and technology promotion survey	6,944	9,453
Space Development Association	106,757	116,293
Ocean development research	10,675	10,472
Ocean Science and Technology Center	10,359	9,645
Japan Nuclear Development Research Institute	94,845	97,587
Japan Reactor Development Center	61,217	56,643
National Nuclear Research Laboratory	2,043	2,060
Research management costs	9,867	10,667
Environment Agency		
National Environment Research Institute	4,556	4,899
Global environmental research	0	1,200
National Disaster Prevention Institute	2,283	1,928
Disaster prevention survey	869	1,015
Foreign Ministry		
International Atomic Energy Commission	2,616	2,956
OECD Nuclear Power Committee	191	200
Finance Ministry		
Brewing Research Institute	348	358
Education Ministry		
Research grants	52,600	55,800
Japan Technology Promotion Council grants	5,568	6,148
University research programs	657,517	689,721
National university research grants	128,366	129,907
Health Ministry		
Agency research	15,125	15,706
Research grants	17,825	18,844
Pharmaceutical research	2,400	2,300
Health science research	5,464	6,467
Cancer research projects	3,204	3,254
International cancer research	129	170
Medical and drug information system	212	242
Agriculture Ministry		
Agency research laboratories (including 29 agricultural research centers)	57,455	59,221
Large-scale projects	1,300	1,302
Biotechnology development	1,509	1,565
Large-scale agriculture research	1,300	1,302
Livestock research	4,244	4,171
Tropical agriculture research	624	672
Red tide research	288	278
Food product technology	518	589

Table 7 (continued)

(in millions of yen)

	FY 1989	FY 1990
International Trade and Industry Ministry		
Agency research (including 16 research centers)	40,248	40,849
Large-scale industrial technology projects	12,993	13,161
Basic computer technology development	3,722	3,462
Basic Technology Promotion Center	26,000	26,000
Next-generation basic technology projects	6,836	7,463
New energy technology development projects	27,139	27,475
Energy conservation projects	10,305	11,120
Nuclear energy development projects	27,434	29,772
Human Frontiers Science Program	932	1,337
International aircraft development	4,190	3,817
Global Environment Industrial Technology Institute	290	6,910
Small business technology improvement	1,630	1,612
Transportation Ministry		
Agency research (including five ship technology centers)	7,369	8,595
Geostationary weather satellite management	2,251	2,130
Geostationary weather satellite launches	3,481	3,272
Magnetic levitation train technology	900	2,017
Next-generation ship technology	746	800
Posts and Telecommunications Ministry		
Electrotechnical laboratories	4,341	4,468
Communications Frontier Research	247	389
Basic Technology Promotion Center	26,000	26,000
Labor Ministry		
Agency research	2,706	2,432
Industrial safety research	1,626	1,354
Japan Bioassay Research Center	1,238	1,313
Construction Ministry		
Agency research (including one engineering center)	4,654	5,426
Construction technology research	709	733

Source: Japan Society for the Promotion of Science, Japanese Scientific Monthly, July 1990.

Table 8: Japan's R&D Expenditures by Industry, FY 1987-FY 1988

(in billions of yen and percentage change)

	FY 1987		FY 1988	
	Total	Change	Total	Change
Agriculture	Y5.8	33.0%	Y8.2	41.4%
Mining	19.5	-9.8	28.1	44.1
Construction	128.3	5.9	148.5	15.7
Manufacturing	6,101.2	6.3	6,754.6	10.7
Food Products	179.1	21.7	179.3	0.1
Textiles	66.5	6.0	72.8	9.5
Pulp and Paper	33.5	-1.3	42.8	27.8
Publishing and Printing	21.7	32.0	25.4	17.1
Chemicals	1,095.9	11.4	1,190.2	8.6
Industrial Chemicals and Synthetic Fibers	452.5	10.6	501.5	10.8
Oils and Paints	111.4	13.9	116.3	4.4
Pharmaceuticals	380.7	11.3	416.2	9.3
Other	151.2	12.2	156.2	3.3
Petroleum and Coal Products	70.2	2.3	75.0	6.8
Plastic Products	85.9	22.8	90.9	5.8
Rubber Products	85.2	6.2	101.5	19.1
Nonmetallic Mineral Products	177.9	-5.2	198.6	11.6
Steel	245.2	-4.0	249.7	1.8
Nonferrous Metals	104.4	-5.2	120.3	15.2
Fabricated Metal Products	94.8	0.2	89.6	-5.5
Nonelectric Machinery	418.8	10.5	451.0	7.7
Electric Machinery	2,163.5	9.3	2,451.6	13.3
Communications and Electronics Equipment	1,497.8	10.1	1,709.8	14.2
Other	665.7	7.4	741.8	11.4
Transportation Equipment	969.6	-2.0	1,086.4	12.0
Motor Vehicles	814.8	-3.1	932.4	14.4
Other	154.8	3.7	154.0	-0.5
Precision Machinery	204.2	2.5	238.8	16.9
Other	84.9	4.6	90.8	6.9
Transportation, Communications and Utilities	239.4	2.6	279.9	16.9
Total	6,494.3	6.1	7,219.3	11.2

Source: Management and Coordination Agency, Report on the Survey of Research and Development.

Table 9: Japan's Ratio of Corporate R&D Expenditures to Gross Sales by Industry, FY 1978-FY 1988

(in percent)

Industry	FY 1978	FY 1983	FY 1987	FY 1988
Agriculture	0.60%	0.26%	0.31%	0.38%
Mining	0.54	0.59	1.01	1.27
Construction	0.42	0.53	0.51	0.49
Manufacturing	1.82	2.31	3.14	3.15
Food Products	0.51	0.70	0.99	0.89
Textiles	0.77	0.90	1.42	1.50
Pulp and Paper	0.49	0.63	0.77	0.87
Publishing and Printing	0.36	0.43	0.80	0.63
Chemicals	2.71	3.34	4.53	4.63
Industrial Chemicals and Synthetic Fibers	1.92	2.32	3.76	3.92
Oils and Paints	2.73	2.83	3.85	3.74
Pharmaceuticals	5.00	6.59	6.96	6.94
Other	3.03	3.04	4.00	4.11
Petroleum and Coal Products	0.27	0.26	0.64	0.83
Plastic Products	n.a.	n.a.	2.16	2.21
Rubber Products	2.60	2.40	3.25	3.19
Nonmetallic Mineral Products	1.29	1.82	2.82	2.73
Steel	1.08	1.60	2.40	2.13
Nonferrous Metals	1.00	1.49	1.90	2.00
Fabricated Metal Products	1.08	1.31	1.50	1.48
Nonelectric Machinery	1.93	2.57	2.99	2.60
Electric Machinery	3.74	4.70	5.61	5.53
Communications and Electronics Equipment	3.89	4.85	5.78	5.66
Other	3.59	4.40	5.26	5.25
Transportation Equipment	2.44	2.66	3.22	3.31
Motor Vehicles	2.60	2.89	3.17	3.31
Other	1.90	1.86	3.45	3.31
Precision Machinery	3.15	4.02	4.91	4.85
Other	1.16*	1.30*	1.12	1.14
Transportation, Communications and Utilities	0.35	0.39	0.84	0.95
All Industry Average	1.57	1.97	2.59	2.60

*Includes plastic products.

Source: Management and Coordination Agency, Report on the Survey of Research and Development.

Table 10: Japan's Corporate R&D Expenditures by Purpose, FY 1987-FY 1988

(in billions of yen and percentage share)

	Basic Research		Applied Research		Developmental Research	
Industry	1987	1988	1987	1988	1987	1988
Agriculture	3.6%	5.4%	16.2%	33.4%	80.3%	61.2%
Mining	17.9	23.0	16.5	31.3	65.5	45.7
Construction	6.9	5.7	26.4	29.7	66.7	64.6
Manufacturing	6.4	6.3	21.2	21.2	72.4	72.5
Food Products	9.2	10.1	29.9	31.7	60.9	58.2
Textiles	6.0	6.2	29.0	30.6	65.0	63.2
Pulp and Paper	7.4	5.1	32.9	31.1	59.7	63.8
Publishing and Printing	2.6	2.8	22.7	29.9	74.8	67.3
Chemicals	11.5	11.9	29.5	29.4	59.0	58.7
Industrial Chemicals and Synthetic Fibers	8.5	8.8	31.1	32.3	60.3	58.9
Oils and Paints	4.8	5.2	31.3	34.9	63.9	60.0
Pharmaceuticals	17.8	18.8	30.7	28.3	51.5	53.0
Other	9.5	8.7	20.0	19.1	70.5	72.2
Petroleum and Coal Products	14.1	13.3	20.7	20.9	65.1	65.9
Plastic Products	6.6	6.8	26.4	28.5	67.0	64.7
Rubber Products	5.3	4.8	17.6	17.0	77.0	78.2
Nonmetallic Mineral Products	8.1	7.6	21.9	20.1	70.0	72.3
Steel	7.8	9.8	25.9	24.5	66.4	65.7
Nonferrous Metals	3.5	3.5	27.4	28.9	69.0	67.6
Fabricated Metal Products	2.4	2.2	12.9	13.3	84.7	84.5
Nonelectric Machinery	4.4	4.4	19.9	20.4	75.7	75.2
Electric Machinery	4.4	4.3	18.7	19.1	76.9	76.6
Communications and Electronics Equipment	4.3	4.2	18.1	18.6	77.6	77.1
Other	4.8	4.5	19.8	20.1	75.4	75.4
Transportation Equipment	4.9	4.7	15.6	14.3	79.5	81.0
Motor Vehicles	4.9	4.6	14.0	12.9	81.1	82.5
Other	5.0	5.5	23.8	22.8	71.3	71.7
Precision Machinery	5.4	4.2	18.4	18.6	76.2	77.2
Other	7.8	4.3	14.8	19.9	77.3	75.8
Transportation, Communications and Utilities	11.7	12.5	30.8	28.2	57.4	59.3
All Industry Average	6.6	6.6	21.7	21.7	71.7	71.7

Source: Management and Coordination Agency, Report on the Survey of Research and Development.

Table 11: Japan's Technology Imports, FY 1950-FY 1988

(number of approved cases and value in billions of yen)

	Cases		Value	
	Total	Of Which New:	Total	Of Which New:
FY 1950-FY 1955	1,148	n.a.	Y24.9	n.a.
FY 1960	588	n.a.	34.2	n.a.
FY 1965	958	n.a.	60.1	n.a.
FY 1970	1,768	n.a.	155.9	n.a.
FY 1975	6,766	796	169.1	Y13.3
FY 1976	6,050	632	177.3	17.9
FY 1977	6,659	685	190.1	16.9
FY 1978	6,573	936	192.1	38.2
FY 1979	7,012	1,020	241.0	26.8
FY 1980	7,248	919	239.5	27.7
FY 1981	7,207	844	259.6	24.9
FY 1982	6,936	929	282.6	44.4
FY 1983	7,839	1,073	279.3	42.4
FY 1984	7,316	982	281.4	31.8
FY 1985	7,679	1,245	293.2	33.3
FY 1986	8,635	1,141	294.2	33.6
FY 1987	8,186	813	339.4	56.2
FY 1988	9,738	1,382	366.8	54.6

Table 12: Japan's Technology Exports, FY 1950-FY 1988

(number of approved cases and value in billions of yen)

	Cases		Value	
	Total	Of Which New:	Total	Of Which New:
FY 1950-FY 1955	n.a.	n.a.	Y0.3	n.a.
FY 1960	n.a.	n.a.	0.8	n.a.
FY 1965	n.a.	n.a.	6.1	n.a.
FY 1970	861	n.a.	21.2	n.a.
FY 1975	2,811	1,073	66.6	Y18.9
FY 1976	2,767	775	83.4	27.0
FY 1977	2,880	897	93.3	36.3
FY 1978	3,157	1,063	122.0	47.1
FY 1979	3,667	1,087	133.1	52.1
FY 1980	4,103	1,237	159.6	74.3
FY 1981	4,877	2,017	175.1	70.8
FY 1982	4,738	1,970	184.9	63.3
FY 1983	6,403	2,494	240.9	74.9
FY 1984	5,426	1,824	277.5	90.9
FY 1985	5,885	2,099	234.2	73.3
FY 1986	7,199	1,730	275.9	51.8
FY 1987	7,610	1,655	260.1	44.8
FY 1988	8,202	1,850	293.7	47.4

Source: Management and Coordination Agency, Report on the Survey of Research and Development.

Table 13: Japan's Corporate Technology Trade by Industry, FY 1987-FY 1988

(number of cases and value in billions of yen)

	FY 1987				FY 1988			
	Exports		Imports		Exports		Imports	
	Cases	Value	Cases	Value	Cases	Value	Cases	Value
Total	5,955	Y215.6	7,373	Y283.2	6,352	Y246.3	8,356	Y312.2
Agriculture	5	0.1	4	0.0	8	0.1	5	0.0
Mining	12	1.0	41	0.2	11	0.1	35	0.1
Construction	229	12.8	151	0.9	387	16.8	171	1.0
Manufacturing	5,681	200.8	7,155	281.0	5,887	228.6	8,119	309.5
Food Products	96	5.0	103	9.8	118	5.8	123	13.4
Textiles	228	4.4	123	3.7	191	4.4	143	4.9
Pulp and Paper	30	0.4	35	0.5	29	0.5	27	0.8
Publishing	15	0.1	52	0.6	29	0.4	70	0.9
Chemicals	1,161	39.3	898	40.6	1,185	48.1	1,044	50.3
Synthetic Fibers	497	18.9	439	14.9	561	27.1	446	20.5
Fertilizers	234	3.0	131	3.7	241	3.1	259	4.3
Pharmaceuticals	285	16.1	210	13.6	294	16.3	231	18.2
Other	145	1.3	118	8.4	89	1.6	108	7.3
Petroleum and Coal Products	11	0.3	97	3.5	12	0.2	103	2.2
Plastic Products	81	1.3	77	0.9	95	1.3	84	1.2
Rubber Products	72	3.1	92	3.3	93	2.9	105	3.7
Nonmetallic Mineral Products	210	6.2	158	6.6	277	5.7	154	3.7
Steel	373	10.0	410	8.0	422	10.8	359	7.9
Nonferrous Metals	173	2.6	201	10.7	207	2.0	195	14.6
Fabricated Metal Products	170	1.3	238	2.9	155	1.1	172	2.2
Nonelectric Machinery	665	8.7	998	21.3	700	10.8	1,112	22.6
Electric Machinery	1,415	61.1	2,422	109.5	1,476	68.8	2,889	113.8
Machine Tools	598	21.3	441	34.5	670	21.0	473	34.5
Electronics	817	39.8	1,981	75.0	806	47.7	2,416	79.3
Transportation Equipment	688	49.2	876	48.8	684	58.4	789	52.0
Motor Vehicles	444	46.0	296	8.4	447	54.2	260	6.6
Other	244	3.2	580	40.4	237	4.2	529	45.4
Precision Machinery	124	2.9	249	6.7	114	4.6	255	7.3
Other	169	4.7	126	3.8	100	2.8	495	8.1
Transportation, Communications and Utilities	28	0.9	22	0.8	59	0.7	26	1.6

Source: Management and Coordination Agency, Report on the Survey of Research and Development.

Table 14: Japan's Corporate Technology Trade by Country, FY 1985-FY 1988

(number of cases and value in billions of yen)

a. Exports

	FY 1985		FY 1986		FY 1987		FY 1988	
	Cases	Value	Cases	Value	Cases	Value	Cases	Value
Asia	3,047	Y87.5	2,748	Y86.5	3,152	Y86.4	3,264	Y101.4
China	417	26.4	454	19.7	405	9.4	339	8.4
Taiwan	559	7.9	532	8.5	590	12.3	660	13.2
South Korea	798	18.2	732	21.1	816	27.5	888	30.6
Thailand	214	6.2	203	5.4	294	7.3	331	9.9
Philippines	320	4.4	89	0.6	133	2.0	n.a.	n.a.
Indonesia	174	5.2	196	4.4	182	3.2	228	13.6
Malaysia	320	4.4	128	3.2	147	3.1	128	4.0
West Asia	167	14.1	94	10.5	52	1.6	59	2.3
North America	1,058	58.7	1,006	62.3	1,058	72.5	1,225	77.0
United States	896	51.8	869	57.7	912	65.9	1,080	71.1
South America	243	8.7	216	5.2	198	4.5	195	4.4
Brazil	133	3.3	127	3.8	107	2.5	114	2.5
Europe	1,072	45.5	1,040	43.6	1,184	40.3	1,281	49.3
Great Britain	183	5.3	161	7.6	190	10.6	221	13.9
West Germany	253	11.3	247	7.8	297	7.4	301	10.7
France	129	4.8	145	5.9	162	5.2	137	4.4
Netherlands	41	4.8	41	2.5	53	2.1	86	2.2
Switzerland	44	3.3	53	3.8	52	2.3	63	1.4
Africa	135	6.6	189	9.5	147	5.0	141	6.0
Oceania	163	13.0	176	6.6	164	5.3	187	5.9
Australia	124	11.9	139	5.8	116	4.2	134	5.2

b. Imports

	FY 1985		FY 1986		FY 1987		FY 1988	
	Cases	Value	Cases	Value	Cases	Value	Cases	Value
Asia	169	Y0.9	15	Y0.3	12	Y0.1	29	Y0.2
China	114	0.7	4	*	2	*	0	0.0
Taiwan	1	*	0	0.0	2	*	15	0.0
South Korea	52	0.0	4	*	4	*	4	*
West Asia	2	*	94	10.5	2	*	0	0.0
North America	4,814	210.3	4,926	174.6	4,747	179.3	5,591	198.1
United States	4,772	208.6	4,825	173.8	4,667	178.6	5,495	196.9
South America	1	*	4	*	3	*	1	*
Europe	2,664	81.6	2,516	85.1	2,568	103.4	2,706	113.6
West Germany	859	17.6	903	20.7	847	21.4	835	18.4
Great Britain	566	14.6	477	13.0	512	10.3	451	9.3
France	285	6.8	298	7.3	313	22.1	432	26.2
Switzerland	319	16.3	241	17.5	273	17.4	277	18.4
Netherlands	156	15.5	163	15.6	173	20.8	182	27.6
Africa	1	*	3	*	3	*	0	0.0
Oceania	28	0.3	28	0.4	38	0.3	29	0.3

*Less than Y50 million.

Source: Management and Coordination Agency, Report on the Survey of Research and Development.

Table 15: Summary of Early Participants in the Human Frontiers Science Program

Research Grants	Number	Amount
Japan	9	$2,660,000
United States	8	1,900,000
United Kingdom	5	1,285,000
France	3	875,000
West Germany	1	300,000
Netherlands	1	250,000
Belgium	1	200,000
Canada	1	200,000
Total	29	7,670,000

Long-Term Fellowships By Nationality	Brain Functions	Molecular Studies	Total	Applicants
Japan	4	14	18	52
United States	0	9	9	19
United Kingdom	5	12	17	33
France	3	3	6	17
West Germany	1	4	5	15
Italy	1	2	3	15
European Community	2	4	6	11
Canada	2	3	5	8
Other	3	8	11	32
Total	21	59	80	202

By Host Country	Brain Functions	Molecular Studies	Total
Japan	0	4	4
United States	13	32	45
United Kingdom	1	4	5
France	2	5	7
West Germany	0	8	8
Italy	0	0	0
EC	1	1	2
Other	4	5	9
Total	21	59	80

By Host Organization	Brain Functions	Molecular Studies	Total
University of California	3	4	7
Salk Institute for Biological Studies	2	2	4
Max Planck Institute for Biophysics and Chemistry	0	4	4
Harvard University	1	2	3
California Institute of Technology	0	3	3
European Molecular Biology Laboratory	0	3	3
Utrecht University (Netherlands)	1	1	2
Stanford University	1	1	2
University of Colorado	1	1	2
Massachusetts Institute of Technology	0	2	2
Institute for Molecular Genetics	0	2	2
Cold Spring Harbor Laboratories	0	2	2
McGill Cancer Center	0	2	2
CNRS Institut de Biologie Physico-Chimique	0	2	2
Others	16	24	40
Total	25	55	80

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JEI

REPORT

A Two-Part Report: A and B

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IN THIS ISSUE:

Japan's GNP Registers Modest Spring Increase 1

G-7 Discusses Economic Response
To Persian Gulf Crisis 4

Debate On Japan's Middle East Role Continues 5

New Defense White Paper
Deemphasizes Soviet Threat 7

Kansai Airport Contract Dispute Continues 9

Textile Bill Action Hints At Congressional
Reception Of Uruguay Round Results 10

Japan's GNP Registers Modest Spring Increase

For those concerned about the health of the Japanese economy the Economic Planning Agency's figures for gross national product in the April-June 1990 quarter bore good news and bad. The good news was that the economy continued to grow at a healthy 3.6 percent annual clip in price-adjusted terms (see Table). While lower than the January-March period's real annualized 11.4 percent rate, the latest quarterly figures suggest that Japan's economic expansion continues on track. In one important respect the economy continued a trend welcomed on both sides of the Pacific: domestic demand was up sharply, while net export demand declined. Domestic demand added 2.4 percentage points to the 0.9 percent quarter-to-quarter gain, while the foreign sector shaved a relatively large 1.5 points off the overall growth rate. The decline in real exports undoubtedly was partly a reaction to developments in the January-March quarter when net exports contributed an unusual 1.3 points to GNP growth.

The bad news came in the composition of domestic growth. As in other recent quarters, plant and equipment spending led the way in the April-June period. Private fixed nonresidential investment added nearly as much to the growth rate as consumer spending even though it is only half as large. Together, these two sectors accounted for most of the growth in domestic demand. Much of the remainder resulted from the growth of private inventories. The performance of consumer spending is determined partly by the spillover effects of changed demand elsewhere in the economy, including plant and equipment spending, while inventory growth typically is erratic. Thus, business investment easily ended up the most important component in the second-quarter GNP increase.

The problems stemming from the composition of domestic demand arise from recent events affecting the Japanese economy. The Bank of Japan raised the discount rate August 30 to 6 percent, the highest level since December 1981 (see JEI Report No. 35B, September 14, 1990). The objective was to prevent the economy from overheating. While the four discount rate hikes since May 1989 have done little to cool investment fever among Japanese companies, some observers in Japan feel the latest boost might do the trick, especially since uncertainty over the outlook for the economy has increased with the crisis in the Persian Gulf. Furthermore, should that crisis portend even higher international oil prices and general inflation, the Bank of Japan has signaled its willingness to ratchet up rates still more. With interest-sensitive investment, such as that for plant and equipment, directly accounting for a substantial chunk of overall growth and indirectly for an additional amount, BOJ obviously is involved in a high-wire act with respect to its interest rate policy. Too little restraint could lead to increased inflationary pressures; too much could send the economy into a deep freeze.

Prospects for future plant and equipment spending are somewhat mixed. Some reports suggest that, faced with higher interest rates and a weak stock market, firms are pushing back spending plans to FY 1991, which begins next April. However, a Japan Development Bank survey conducted among 2,158 companies August 20 and released September 20 revealed that the respondents plan to increase investment a whopping 17 percent in nominal terms in the current fiscal year. Compared to the bank's February survey, the latest results indicate an upward revision of 8.4 points.

Japanese analysts generally remain confident that BOJ will pull off its risky interest-rate maneuver. Few believe that the increases in world oil prices and Japanese interest rates will have any immediate effect on the economy; in fact, the Japan Economic Research Center has pegged GNP growth in the July-September period at a remarkable 2.5 percent on a real quarter-to-quarter basis. The Economic Planning Agency agrees that third-quarter results will show little impact from recent events. Even after accounting for the run-up in oil prices through the end of August and the discount rate increase, Sumitomo Bank, Ltd. predicted in early September that FY 1990 will end up with a real GNP growth rate of 4.3 percent, off a mere tenth of a point from what the bank expected prior to the onset of the Persian Gulf crisis. Other banks and research institutions have made similar projections.

A growing number of analysts believe, however, that over the longer term Japan will not escape unscathed by the combination of recent events and the maturity of its economic expansion. Josen Takahashi, senior economist at Mitsubishi Research Institute and traditionally known for his pessimistic outlook,

Japan's Real Gross National Product at Constant (1980) Prices

(in billions of yen, seasonally adjusted, quarterly totals and rates of growth at annual rates)

	FY 1988	FY 1989	July-September 1989	October-December 1989	January-March 1990	April-June 1990
Gross National Product	Y334,968.8 (5.3%)	Y352,085.9 (5.1%)	Y350,436.1 (12.1%)	Y353,352.3 (3.4%)	Y363,040.6 (11.4%)	Y366,220.7 (3.6%)
Personal Consumption Spending	185,317.8 (5.0%)	191,184.3 (3.2%)	190,316.4 (8.2%)	193,336.8 (6.5%)	194,194.5 (1.8%)	196,970.3 (5.8%)
Private Residential Construction	20,686.8 (5.3%)	21,502.2 (3.9%)	21,328.5 (9.4%)	21,744.6 (8.0%)	22,188.8 (8.4%)	22,578.3 (7.2%)
Private Fixed Nonresidential Investment	72,617.1 (17.3%)	84,760.2 (16.7%)	83,374.1 (28.4%)	86,710.4 (17.0%)	89,758.9 (14.8%)	93,182.0 (16.1%)
Change in Business Inventories	2,080.6 (*)	1,821.5 (*)	2,077.4 (*)	2,117.2 (*)	686.4 (*)	2,068.4 (*)
Government Current Expenditures	29,341.5 (2.2%)	29,908.5 (1.9%)	29,732.0 (1.0%)	30,013.5 (3.8%)	30,233.6 (3.0%)	30,218.8 (-0.2%)
Government Fixed Investment	24,621.6 (1.2%)	24,543.3 (-0.3%)	24,205.1 (-5.4%)	24,509.2 (5.1%)	24,842.4 (5.5%)	25,370.1 (8.8%)
Change in Government Inventories	-185.0 (*)	-35.9 (*)	63.4 (*)	-949.1 (*)	357.9 (*)	526.9 (*)
Net External Sector	488.4 (-33.7%)	-1,598.2 (-427.2%)	-660.8 (235.3%)	-4,130.3 (*)	778.1 (*)	-4,694.1 (*)
Exports of Goods and Services and Factor Income Received	61,457.7 (10.7%)	71,120.7 (15.7%)	70,171.1 (29.1%)	71,054.2 (5.1%)	77,542.1 (41.8%)	74,531.1 (-14.7%)
Imports of Goods and Services and Factor Income Paid	60,969.3 (21.4%)	72,718.9 (19.3%)	70,831.9 (17.3%)	75,184.5 (26.9%)	76,764.0 (8.7%)	79,225.2 (13.5%)

*Cannot be calculated or meaningless.

Source: Economic Planning Agency

believes that the Japanese economy could sharply decelerate and enter a recession as early as the upcoming October-December quarter. (A recession in Japanese terms implies a sharp slowdown in growth, not negative GNP growth as it does to most analysts of the U.S. economy.) Many others believe that the crunch could come sometime next year. If it occurs before next summer, Japan's current economic expansion would fall just short of achieving the record as the longest expansion in postwar Japanese history. However, optimists have by no means disappeared. Hisao Kanamori, chairman of the influential Japan Economic Research Center, believes growth will approximate an inflation-adjusted 4 percent even in FY 1991. While a handful of analysts are even more optimistic, most expect real GNP growth to average slightly less than 4 percent, still a remarkable performance for an economy that could experience its fifth full year of expansion in FY 1991.

Douglas Ostrom

G-7 Discusses Economic Response To Persian Gulf Crisis

September 22 marked an important anniversary in efforts at international economic coordination. Yet when the finance ministers and central bank chiefs of the seven leading industrialized countries met on that day in Washington to discuss economic policy, they appeared to ignore the coincidence. Exactly five years earlier representatives of five of the seven members of the group had held their now-famous meeting in New York City to hammer out what became known as the Plaza Accord -- an agreement that significantly realigned international exchange rates. (The United States, Japan, Great Britain, France and West Germany participated in the 1985 meeting; Canada and Italy were excluded.)

The lack of commemoration this year may have symbolized growing doubts about the efficacy of the process, even though the immediate objective of the 1985 accord was easily achieved and then some. The dollar dropped against the yen and the currencies of most other industrial nations for the balance of 1985 and for most of the next three years. Against the yen it dipped to as little as half its September 1985 high of Y244.1=$1.00; in the last two years the dollar-yen exchange rate has fluctuated, with the dollar generally headed upward.

The dollar-yen exchange rate has continued to receive emphasis, however. For example, at their May 1990 meeting the Group of Seven participants expressed the view that "the present level may have undesirable consequences for the global adjustment process." That view presumably implied that the yen's then current value of approximately Y158=$1.00 was too low. If so, its Y136.65 value prior to the September 22 meeting presumably was more appropriate. Apparently supporting this view, the latest G-7 communique noted that "exchange rates were now broadly in line with continued adjustment of external balances," adding that the participants "agreed to cooperate closely on exchange markets in the context of the economic coordination process."

Despite the soothing words of the communique, some Japanese and European participants reportedly were less than happy. Not that they have any problems with the current dollar-yen exchange rate; complaining that the yen is too strong hardly would be consistent with worries over its weakness just four months earlier. Instead, the disagreements centered on the appropriate policy

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A Two-Part Report: A and B

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JAPAN'S EMERGING ROLE IN INTERNATIONAL FINANCIAL MARKETS

Summary

Japan remained the world's largest international creditor in 1989, but the growth of its net assets slowed dramatically. Moreover, the weakness of Japanese domestic financial markets this year is casting a long shadow on Japanese financial activities worldwide and has led some analysts to conclude wrongly that Japanese firms are supplying significantly less capital to world markets than previously.

Until 1981 the United States was the world's biggest international creditor. The dollar's important role in denominating international trade and cross-border financial assets coexisted with this creditor position. A few analysts have predicted the same future status for the yen. Despite the growing global financial clout of Japanese companies, the yen is used relatively little in international transactions, with the dollar continuing the dominance it has had throughout the postwar period. In many respects the dollar's strong role is an advantage for the United States, although it does bring commensurate responsibilities. Should the yen eventually achieve a significantly greater international status, similar costs and benefits would devolve on Tokyo.

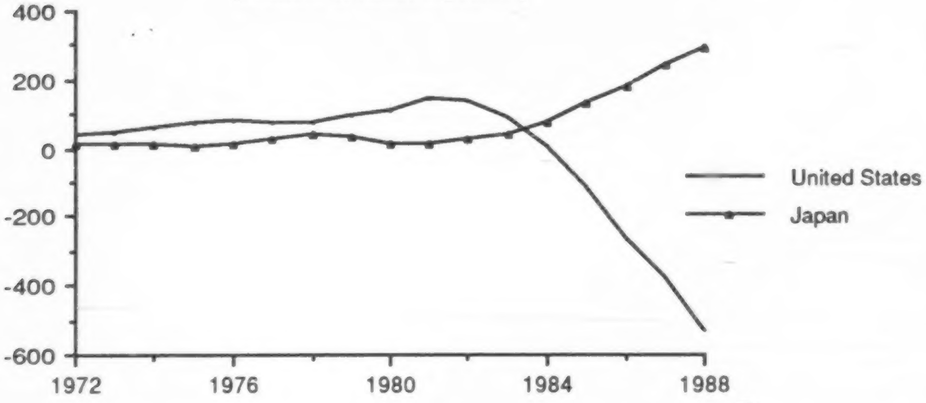
Japan's Emergence as an International Creditor

As the 1990s dawned American public opinion had grown accustomed to viewing Japan as the world's main creditor. From venture capital firms to municipal governments, Americans appeared to be going cup in hand to Tokyo and its financial powerhouses. The federal government, too, struggling to finance its budget deficit and its growing military force in the Persian Gulf, pressed Tokyo for international financial commitments. Some press reports even suggested that Japanese investors had life or death say over U.S. financial markets.

These arguments resonated particularly strongly because the United States had become the world's largest debtor (see Figure). While many experts, including those in the Department of Commerce who assemble the components of this country's international financial balance sheet, believe that the data exaggerate America's debtor status, few doubt that the U.S. position deteriorated significantly during the 1980s.

Net International Investment Positions

(in billions of dollars at yearend)



Source: Bank of Japan and Department of Commerce

Japan's role as the world's largest creditor, however, does not mean that it has a commensurate role as supplier of new funds to world capital markets in a given year. Moreover, the rate of growth of Japan's overseas assets slowed dramatically in 1989, suggesting that the popular image of Japanese financial institutions as the world's financiers was considerably exaggerated. Furthermore, being the largest creditor has not immunized Japanese markets from financial shocks. Japan's stock market, which some analysts reckoned had enjoyed a 20-year run of rising prices has plummeted this year, enabling the New York Stock Exchange to reclaim its title from the Tokyo Stock Exchange as the world's largest. As of mid-September the total market value of stocks on the Tokyo Stock Exchange was lower than at any time since June 1987.

Sources of Japan's International Financial Clout

Japan's position as the world's largest creditor is closely related to its balance of payments. A surplus of exports over imports implies net overseas investment. Japan's diminishing current account surplus, which has dropped by more than one-third in dollar terms since peaking in 1987, corresponds to a

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smaller outbound capital flow. Both the current account and net investment depend on the relationship between savings, investment and government spending in the economy. Between 1985 and 1989 Japanese personal savings rates dipped slightly and plant and equipment spending boomed, suggesting a reduction in the private-sector imbalance, which actually became negative in 1989. However, the fiscal balance, the amount made available on capital markets by the actions of central and local governments, grew substantially. The net result was a decline in surplus savings available for investment abroad (see Table 1).

Table 1: Current Account and Government and Private Domestic Imbalances in Japan, United States and West Germany

(percent of GNP)

	1981	1986	1989
Japan			
Current Account	0.4%	4.3%	2.0%
Fiscal Balance*	-3.8	-0.9	2.8
Private Net Savings**	4.4	5.3	-0.5
Discrepancy***	0.2	0.1	1.3
United States			
Current Account	0.3	-3.1	-2.0
Fiscal Balance*	-1.0	-3.4	-2.0
Private Net Savings**	1.1	0.2	0.8
Discrepancy***	-0.2	-0.1	0.8
West Germany			
Current Account	-0.5	4.4	4.4
Fiscal Balance*	-3.7	-1.3	0.2
Private Net Savings**	3.1	5.7	4.2
Discrepancy***	-0.1	0.0	0.0

*Central and local governments.

**Gross savings in business and household sectors minus gross investment in business and household sectors.

***Rounding error, statistical discrepancy in the national accounts and coverage differences between national income and current account data.

Source: International Monetary Fund, World Economic Outlook (May 1990).

The United States has experienced the opposite movement: the fiscal imbalance deteriorated rapidly in the early 1980s, although it has improved somewhat in recent years. The surplus of the private sector shrunk between 1981 and 1986, leading to a continuing large capital deficiency, made up by Japan and other nations. While the Japanese surplus available to the United States and other countries declined relative to gross national product between 1986 and 1989, the West German surplus remained unchanged, and at the end of the decade was twice as large relative to GNP as the Japanese surplus. Since Japan's economy is much larger than West Germany's, their current accounts in dollar terms were nearly identical in 1989: a surplus of $57.2 billion in Japan against $52.8 billion in West Germany. As such, the two nations could make almost equal claims last year to the title of world's financier.

With German reunification the West German current account surplus could fall dramatically. Moreover, if Japan's surplus continues to drop and U.S. demands grow to finance its budget deficit -- made possibly much worse if the United States enters a recession -- worldwide capital markets could well tighten. As a result, inflation-adjusted interest rates could rise significantly.

Components of Japan's International Assets

Until regulatory changes made outbound capital flows substantially easier for Japanese firms beginning in 1981, most of Japan's net assets abroad were in the government sector. (For details of Japan's financial liberalization regarding overseas capital flows, see JEI Report No. 42A, November 3, 1989.) As Table 2 shows, government assets abroad exceeded those in the private sector until 1984.

Table 2: Japan's Net External Assets, 1972-89

(in millions of dollars)

End of Year	Private Sector	Government Sector	Total
1972	$-6,820	$20,687	$13,867
1973	-3,021	16,037	13,016
1974	-8,318	17,261	8,943
1975	-10,302	17,320	7,018
1976	-11,653	21,227	9,574
1977	-6,182	28,162	21,980
1978	-2,550	38,764	36,214
1979	850	27,927	28,777
1980	-16,659	28,193	11,534
1981	-18,537	29,455	10,918
1982	2,046	22,636	24,682
1983	11,928	25,331	37,259
1984	47,069	27,277	74,346
1985	104,450	25,371	129,821
1986	138.541	41,810	180,351
1987	146,494	94,250	240,744
1988	147,571	144,175	291,746
1989	158,839	134,376	293,215

Source: Bank of Japan, Balance of Payments Monthly, April 1990.

The rapid depreciation of the dollar against the yen and other key international currencies between 1985 and 1988 ushered in another change. Japanese firms attempting a balance between yen- and dollar-denominated assets in their portfolios had to add more dollar assets to obtain a given mix since the dollars corresponded to fewer yen than previously. In addition, interest rate differentials favored dollar assets. The result was a surge of private-sector foreign holdings denominated in dollars in 1985 and 1986. In 1987 and again in 1988 private investors slowed down the shift of assets abroad, reflecting both progress in portfolio reallocation and the realization that dollar-denominated assets were subject to considerable exchange rate risk as the dollar continued to fall in value. The data hint that the Bank of Japan substituted for these private investors as a source of demand for dollar-denominated assets, thereby slowing the dollar's fall in both years. This apparent BOJ action probably accounted for the surge in net foreign official assets in 1987 and 1988.

In 1989 the relative roles of the public and the private sectors switched again. Now it was the yen's turn to weaken, averaging Y138=$1.00 last year against Y128.2 to the dollar in 1988. This turn of events pleased private investors who, if they opted for dollar-denominated assets, faced the potential for a double-barrelled gain: currency appreciation and higher interest rates. As the dollar gained strength on the basis of this self-fulfilling prophecy, the Bank of Japan appeared to lean against the wind, selling dollar-denominated assets and reducing its foreign exchange reserves. As a result, government net external assets dropped slightly in 1989, while private-sector assets rose.

Partial data for 1990 are available for Japan's foreign exchange reserves but not for other public- or private-sector assets. These reserves, which stood at $84.9 billion at the end of 1989, dropped further during the first four months of this year, bottoming out at $73 billion April 30, a move that coincided with a period of weakness for the yen. The Japanese currency averaged Y158.5=$1.00 for April, its worst showing since December 1986. In more recent months foreign exchange reserves have risen along with the yen, hitting $75.3 billion in September when the yen averaged Y139=$1.00.

Table 3 shows a breakdown of Japan's external assets and liabilities in 1988 and 1989. The country's net securities position actually declined last year, falling from $172.3 billion to $159.8 billion or 7.3 percent, even though yearend holdings of foreign securities increased sharply from $427.2 billion to $533.8 billion. The drop in net assets probably resulted from increased Japanese corporate fund-raising in international capital markets, reflected in the figures by the jump in liabilities under the stock and bonds heading. For example, the value of international bonds outstanding issued by Japanese entities rose from $184.2 billion in 1988 to $266 billion in 1989, according to the Bank for International Settlements.[1] The international bond market drew considerable strength from equity-related bonds; with the drop in the Japanese stock market in 1990, however, this portion of the international bond market has virtually disappeared because the right to obtain equities on favorable terms has become much less valuable.

In short, in 1989 both the asset and the liability figures for securities jumped, reflecting the internationalization of Japanese capital markets. While comparable 1990 data are not available, the growth of liabilities and assets appears to have dropped sharply. For example, Japanese balance of payments

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[1] Bank for International Settlements, 60th Annual Report (Basle, Switzerland: 1990), p. 145.

Table 3: Japan's External Assets and Liabilities, 1988 and 1989

(in millions of dollars)

	Assets		Liabilities	
	End of 1988	End of 1989	End of 1988	End of 1989
Long-Term	$832,669	$1,019,218	$311,625	$447,472
Private Sector	728,168	901,736	268,431	405,498
Direct Investments	110,780	154,367	10,416	9,160
Trade Credits	48,791	52,866	23	16
Loans	123,663	137,084	1,061	18,895
Securities	427,218	533,781	254,886	373,990
Others	17,716	23,638	2,045	3,437
Government Sector	104,501	117,482	43,194	41,974
Loans	55,570	60,471	26	7
Others	48,931	57,011	43,168	41,967
Short-Term	636,678	751,785	865,976	1,030,316
Private Sector	538,802	666,712	850,968	1,004,111
Monetary Movements	502,256	627,846	765,165	894,679
Others	36,546	38,866	85,803	109,432
Government Sector	97,876	85,073	15,008	26,205
Monetary Movements	97,869	85,072	5,144	16,957
Others	7	1	9,864	9,248
Total	1,469,347	1,771,003	1,177,601	1,477,788

Source: Bank of Japan, Balance of Payments Monthly, April 1990.

data for the first six months of 1990 show that Japanese investors purchased a net $10.2 billion in U.S. Treasury and other foreign bonds, down from $39.1 billion a year earlier. Overseas liabilities also grew more slowly, a result of much less fund-raising by Japanese firms on international money markets and net withdrawals by foreigners from the Japanese stock market. As a result, the net long-term capital outflow dropped to $34.8 billion in the January-June 1990 period from $36.4 billion a year earlier. (For details, see JEI Report No. 33B, August 24, 1990.)

This development has considerable significance for policymakers and contradicts another argument making the rounds in Washington and Tokyo. Juxtaposing balance of payments data that show a drop in Japanese purchases of stocks and bonds worldwide with an apparent net decline of $8.9 billion in Japanese assets held in the United States from January through June of this year, some American and Japanese analysts have sounded an alarm. They fear that Japanese companies finally are staging their dreaded withdrawal from U.S. capital markets. The expected result is sharply higher U.S. interest rates in the wake of the reduced supply of funds, assuming that demand remains roughly unchanged.

This second argument has several obvious problems. First, any U.S. interest rate increase based on Japanese investors' January-June sell-off of U.S. assets already should have occurred. In other words, to the extent that the phenomenon means anything, the pressure for higher interest rates should have begun months ago, not with the announcement of Japan's international payments data in early September. Second, the data used to make the alarmist argument fail to note the other aspects of Japanese international capital flows considered above: the decline in outbound flows was almost matched by a decline in inbound flows. Hence, the net flow -- the amount available to finance activity abroad -- changed little in the first half of the year. Third, the decline in the Japan-U.S. capital flow by itself was almost meaningless. Sources and uses of funds are largely interchangeable; if Japanese investors decide to abandon U.S. assets in favor of those in Europe and elsewhere, then the funds they replace in those third-country markets are available for financing activity in the United States. For these reasons it is no surprise that U.S. interest rates failed to rise significantly between January and June of this year when Japanese funds were being pulled out of U.S. securities markets.

In addition, the wider economic implications that some experts have drawn from Japan's international payments data is incorrect. A number of Japanese analysts have suggested that the apparent abandonment of U.S. capital markets is further evidence of American decline. In fact, recent changes in international money markets have at least as much to do with the fragility of Japanese capital markets. The slowdown in the growth of Japanese international liabilities in 1990's January-June period was largely a consequence of foreign unwillingness to bet on a recovery of the Japanese stock market. In other words, the drop in the growth of both Japanese foreign assets and liabilities at this year's midpoint cannot be assumed to be a result solely of problems in the Amercan economy. The difficulties in Japan's financial markets also played a role.

More generally, the movement of securities between the United States and Japan in 1990 suggests that stock and bond investors on both sides of the Pacific have retreated to their respective home markets. American stock investors, for example, appear to have switched some of their portfolio from Japan to the stronger market on Wall Street. Japanese bondholders increasingly prefer domestic government bonds rather than U.S. bonds. With the nominal interest rate differential between American and Japanese issues less then half a percentage point, Japanese bond investors in effect pay only a slight penalty for avoiding exchange rate risks.

The data in Table 3 and elsewhere do not support a broad conclusion that Japan is becoming significantly less involved as a global investor. For example, as Table 3 shows, Japanese direct investment abroad soared 39.4 percent in 1989. Balance of payments data for 1990 suggest that foreign direct investment grew at least as fast in dollar terms in the first half of this year, although the amount of direct investment outstanding grew slightly more slowly in percentage terms.

Finally, as noted above, world capital markets could tighten in coming years. This raises the possibility that higher interest rates could serve as a magnet pulling funds out of Japan to meet capital shortages elsewhere. Should this happen, Japan's international role as a creditor could expand significantly. Of course, such a scenario would presuppose larger surplus savings in Japan, a development by no means guaranteed.

Internationalization of the Yen

The foregoing argument suggests that Japan is likely to remain a key player in world financial markets despite recent ups and downs of international stock and bond markets. Many observers in Japan, and some in the United States, have argued that Japan should take another step -- internationalize the yen. This would raise its economic profile and possibly also give it increased political clout. While Japan's economic role has increased internationally, that of its currency has changed only marginally up to now. As a result of the international trading regime put in place after World War II, the dollar continues to play the preeminent role in international finance, with supporting roles for other currencies.[2]

"Internationalization" is a term to which several meanings can be applied. Each of these is considered below.

Opening Up Japanese Capital Markets - During the 1984 yen-dollar talks between Japan and the United States, American negotiators essentially argued that foreign investors had only limited means of betting on a rise in the value of the yen. As a result, the yen was said to be undervalued. One product of those talks was progress toward establishing new financial instruments. However, as many critics had predicted, the principal immediate result of financial liberalization in Japan was that outbound capital flows became easier, which led to an increased demand for dollars -- not yen -- with the consequence that the American currency strengthened against the yen. These capital flows, of course, are one of the reasons Japan emerged as the world's largest creditor.

To date, however, a key component of internationalization in this sense had not yet been put in place. Financing bonds, the most important short-term Japanese government security, still are not widely traded and are issued with below-market interest rates, dramatically reducing their appeal for foreign and Japanese investors alike. (The Bank of Japan ends up holding a disproportionate share.) These instruments, as a safe and a potentially highly liquid type of security, normally would be considered a principal means by which foreigners could place bets on the yen; equivalent securities perform this function in the United States regarding the dollar. However, the Ministry of Finance, which probably would have to pay higher interest rates to attract investors, has resisted successfully both foreign and Bank of Japan pressure to introduce changes in this instrument. (The characteristics of FBs also have implications for the conduct of Japanese monetary policy and for relations between MOF and BOJ. For details, see JEI Report No. 27A, July 13, 1990.)

Using the Yen to Denominate International Financial Assets - As noted above, Japanese investors expose themselves to exchange rate risks if they buy dollar-denominated bonds or other financial assets. If the dollar falls between the time they buy the securities and when they sell, they probably will suffer a loss. While various kinds of hedging techniques are possible for many dollar assets, denominating the bonds in yen in the first place obviously would be simpler from the Japanese buyer's standpoint. If the issuer has close relationships with the Japanese companies that effectively set prices in yen, then interest and principal payments also may be less risky for the issuer if the bonds are denominated in yen. Japanese corporations operating overseas obviously fall in this category, as do at least a handful of American firms.

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[2] For a summary of the dollar's international role using concepts generally similar to those employed below, see Peter B. Kenen, "The Role of the Dollar as an International Currency," Group of Thirty Occasional Papers, No. 13 (New York: 1983).

Table 4 shows new issues of yen-denominated international bonds in recent years. From 1986 to 1989 yen-denominated issues showed no consistent gain compared to their dollar-denominated counterparts, although they ranked second to dollar issues in each year except 1987 when they were the largest. Comparable data are not available for the years before 1986, but the yen-denominated share apparently almost doubled between 1983 and 1986.

Table 4: Composition of International Bond Issues, 1986-89

(percentage of total fixed-rate net new issues)

	Total (billions of dollars)	Percentages			
		Dollars	Yen	Pound Sterling	Others
1986	$108.6	42.3%	17.4%	4.5%	35.7%
1987	68.9	15.5	26.7	11.9	45.8
1988	99.4	26.8	12.0	10.5	50.9
1989	89.0	29.1	16.2	12.4	42.2

Source: Bank for International Settlements

Table 5 shows a different dimension of international assets. The composition of foreign currency holdings of banks reporting to the Bank for International Settlements has shown a sharp, fairly continuous swing to the yen in recent years. While the dollar remains dominant, the yen now occupies second place in BIS reported-bank holdings, ahead of the Deutsche Mark. On balance, therefore, the data in Tables 4 and 5 suggest a movement, but not a stampede, toward the yen.

Yen-Denominated Exports and Imports - Traditionally the dollar has reigned supreme in trade to a remarkable degree worldwide. For example, even North Korea, arguably among the world's most hostile nations to the United States, has used the American currency to denominate much of its trade, although relations between Washington and Pyongyang are virtually nonexistent. Japan uses the dollar for trade even when that trade involves third countries; one estimate for 1980 put the dollar-invoiced share of Japanese exports to countries other than the United States at 75 percent.[3]

The prevalence of the dollar makes sense given the U.S. role as the world's largest trader. Both parties to a transaction can minimize risk by using dollars if their remaining costs and revenues are in dollars. For Japanese firms, however, this typically is not the case; most of their costs are in yen. Hence, a dollar-denominated trade contract between an American firm and a Japanese one imposes currency risks on the Japanese company. A Japanese firm can avoid this risk by hedging, but hedges are not costless.

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[3] Ibid., p. 10.

Table 5: Currency Composition of Cross-Border Positions, 1986-89*

(in billions of dollars; changes in asset levels excluding exchange rate effects)

	1986	1987	1988	1989
U.S. Dollar	$188.8	$184.1	$94.6	$137.8
Japanese Yen	20.8	30.7	14.0	38.8
Deutsche Mark	0.9	31.1	31.3	29.5
ECU**	6.2	8.2	15.6	16.4
Pound Sterling	8.5	5.2	22.8	15.7
Swiss Franc	7.9	-1.5	-4.8	2.7
Other	25.2	27.3	39.7	49.9
Total	258.3	285.1	213.2	290.8

*BIS reporting banks.
**European Currency Unit

Source: Bank for International Settlements

A summary of a recent Ministry of International Trade and Industry survey indicated that 75.9 percent of the responding companies complained that exchange rate changes made planning difficult; 46.8 percent said plant and equipment investment decisions similarly were complicated. MITI did not say how the surveyed firms were selected or whether they had a greater than average exposure to foreign trade.[4]

Table 6 shows how the yen's role has changed in Japan's international trade in recent years. Japanese exports are far more likely to be denominated in yen than imports; in part this reflects the fact that industrial and agricultural inputs, which make up nearly half of Japan's imports, are goods traded on international markets and priced in dollars, with crude oil being a prominent example. Earlier data are calculated on a different basis but appear consistent over a period of 20 years with an upward creep in the share of both exports and imports denominated in yen. Yen-denominated exports in 1975, for example, were about half their current share, while imports, at just 0.9 percent, were a fraction of their 1989 level.[5]

Despite the increased use of the yen in Japanese trade, the figures in Table 6 are much lower than equivalent figures for other large industrial countries. The United States invoices virtually all its exports in dollars; West Germany's figure came to 81.5 percent in 1987, the latest year for which data

[4] Ministry of International Trade and Industry, Tsusho Hakusho (Tokyo: Okura-sho Insatsu-kyoku, 1990), p. 95.

[5] For a summary of research on the role of yen in trade and a discussion of the progress of yen internationalization generally, see Jeffrey A. Frankel, The Yen/Dollar Agreement: Liberalizing Japanese Capital Markets (Washington, D.C.: Institute for International Economics, 1984), especially p. 37.

Table 6: Percentage of Japan's Trade Denominated in Yen, 1970-89

	Exports	Imports
1970	0.9%	0.3%
1975	17.5	0.9
1980	29.4	2.4
1985	35.9	7.3*
1989	34.7	14.1

*Fiscal year.

Source: Fuji Research Institute

are available. Similarly, imports are several times more likely to be denominated in home-country currencies in the case of the United States and West Germany than in Japan's case.

The Japanese currency is used far more widely in transactions with some regions than with others. In 1988 only 17 percent of Japanese exports to the United States and 10 percent of its imports from this country were denominated in yen. By contrast, 37.6 percent of Japanese exports to South and East Asia and 17 percent of imports from that region involved yen-based transactions that year. These figures reflect in part the risk-averting advantages of trading in yen in countries where trade with Japan looms large. For example, a Malaysian exporter that uses imports from Japan in the manufacture of its product covers the higher dollar import prices resulting from possible yen appreciation if the company prices its exports in yen.

The Yen as a Reserve Currency - As noted above, both public and private investors stimulate international capital flows. Official actions often are taken to push an exchange rate in one direction or the other. If the Bank of Japan believes the dollar is too strong, for example, it may depress the value of the American currency artificially by making available dollars on international money markets. One reason it can do this is its reserve of dollars. Of course, in theory a central bank could use any number of currencies to intervene in foreign exchange markets and to hold reserves against the day that it runs balance of payments deficits, but in practice the dollar overwhelms other currencies in this respect.

Table 7 shows the trend in reserves. During the early 1970s the dollar lost ground as governments around the world diversified their foreign exchange holdings. More recently, the U.S. currency's share of reserves typically has risen or fallen with the value of the dollar on international currency markets. An appreciating dollar apparently implies less risk for central banks holding the American currency. In 1986 and 1987, however, this pattern was broken; the dollar's share of world foreign exchange holdings rose after authorities added to their dollar reserves as a means of supporting the greenback's value.

The ongoing dependence on the dollar as a reserve currency means that nations continue to rely on the United States as a banker. If the circumstances were right and Washington so chose, this mandate could amount to a license to print money. (Cynics have suggested this possibility explains why Washington

Table 7: Share of National Currencies in IMF Members' Official Foreign Exchange Holdings, 1973-88

	1973	1975	1980	1984	1985	1986	1987	1988
U.S. Dollar	76.1%	79.4%	68.6%	69.4%	64.2%	66.0%	66.8%	63.3%
Deutsche Mark	7.1	6.3	14.9	12.3	14.9	14.9	14.7	16.2
Japanese Yen	0.1	0.5	4.3	5.6	7.8	7.6	7.1	7.2
Pound Sterling	5.6	3.9	2.9	3.0	3.1	2.8	2.7	3.1
French Franc	1.1	1.2	1.7	1.0	1.3	1.2	1.2	1.7
Swiss Franc	1.4	1.6	3.2	2.1	2.3	1.9	1.6	1.5
Other	8.6	7.1	4.4	6.6	6.4	5.5	5.9	7.0

Source: International Monetary Fund, *Annual Report*.

took a leading role setting up the system this way in the aftermath of World War II.) If foreign central banks are willing to hold increased reserves of dollar assets, then the United States indefinitely is free to spend more than it earns in foreign trade. Other nations, rather than objecting to this apparent scam, may even welcome the development since the resultant higher foreign exchange reserves may help lubricate and expand international trade generally. The same would be true for transactions denominated in yen. MITI argues that internationalization of the yen would be desirable in part because it would permit trade to grow faster.[6] The risk is that the increase in reserves would become excessive, with inflated dollar (or yen) prices rather than increased trade.

Washington's role as a large international debtor -- and Japan's as a big creditor -- obviously creates problems when the dollar figures so dominantly. Rapid inflation in the United States could lead to a reduction in the real value of dollar-denominated assets around the world, reducing this country's real debt burden. As large creditors, Japanese firms and the Bank of Japan would be losers. For this reason alone, Tokyo would appear to have a strong interest in the yen playing a more prominent role. In any case, the American currency would appear to be a poor choice to dominate international transactions, yet other factors argue for keeping what may appear to be a fox in charge of the henhouse.

Costs and Benefits of Currency Internationalization

If central banks or private investors are willing to hold a currency as a store of value, the home country can reap profits from increases in the international use of its currency. This role could be in jeopardy, however, if the currency fails as a store of value -- because, for example, inflation in the issuing country is excessive compared to price increases in other countries. Hence, in order to preserve a currency's global position, the Federal Reserve Board and other central banks whose currencies have a reserve role presumably have to be more concerned about inflation than does a central bank on the periphery of international currency markets.

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[6] MITI, *op. cit.*, p. 96.

However, too tight a rein on inflationary forces would be equally counterproductive. In that case, a country like the United States or Japan probably would tend to run a balance of payments surplus. In such a situation partner countries would accumulate fewer foreign exchange reserves -- particularly in the inflation-fighting nation's denomination -- and less liquidity would be available to the international trading system; trade flows could stagnate. With mammoth U.S. trade imbalances in recent years, few would accuse Washington of not doing enough to create liquidity in the system. This example also suggests why surplus countries like Japan may continue to play relatively small international financial roles; its trading partners do not accumulate yen reserves in part because they buy more from Japan than they sell.

The different dimensions of the internationalization of a currency are mutually reinforcing. For example, if dollar-denominated assets are the rule in international financial markets, that fact clearly reinforces their role as foreign exchange reserves. If both private and public foreign financial assets are held mainly in dollars, central banks can substitute easily for private investors in capital markets if private investors abandon dollar-denominated instruments. As described above, the Bank of Japan appeared to play this role in 1987, increasing its reserves. Similarly, if dollars are used to denominate Japan's imports, as they generally are, Japanese firms have an additional reason to hold dollar-denominated financial assets in order to pay for foreign goods. Whenever trade is denominated in dollars, governments will tend to accumulate dollars as foreign exchange reserves, particularly if their country runs a current account surplus.

Given the interdependent roles of a key currency, the past dominance of the dollar as a currency for trade as well as a reserve currency and a private international financial asset is not surprising. The relationships among the different aspects of internationalization direct, in part, powerful forces that tend to concentrate attention on one currency at the expense of others, making it all the more difficult to dislodge a dominant currency like the dollar.[7]

Conclusion

Washington appeared eager during the 1984 yen-dollar talks to reduce its role as manager of the world's preeminent currency. Despite efforts to elevate the yen, the Japanese currency's importance has increased only modestly and the dollar's role diminished only slightly. Japanese policymakers would have had to face the prospect of taking international repercussions even more into account had the yen quickly achieved a much higher profile. That day is slowly approaching. In the meantime, the world's financial and trading systems depend, more than they otherwise would have, on decisions made in Washington. Given

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[7] This argument is developed in the context of bank competitiveness by Gunter Dufey and Adrian Tschoegl, "International Competition in the Services Industries: Institutional and Structural Characteristics of Financial Services," prepared for the U.S. Congress, Office of Technology Assessment, Contract 533-5675.1, February 28, 1986, pp. 149-157. Authors Dufey and Tschoegl conclude that U.S. banks derive a modest competitive advantage from transactions in their home currency. Their argument would seem to suggest that internationalization of the yen might work against the competitive interest of U.S. banks.

Washington's status as the world's largest debtor, some might regard this situation as analogous to the fox supervising the henhouse. At this point, however, inertia and America's large trade imbalance work to preserve the status quo.

For further information, contact Douglas Ostrom.

Shawn Guse provided research assistance.

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The views expressed in this report are those of the author and do not necessarily represent those of the Japan Economic Institute.

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REPORT

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SOCIAL OVERHEAD CAPITAL IN JAPAN

Summary

As part of the recently concluded Structural Impediments Initiative talks with Washington, Tokyo promised to channel Y430 trillion or $3 trillion-plus into public investment between FY 1991 and FY 2000. Increased public spending on infrastructure is expected to narrow Japan's savings-investment gap and, thus, help reduce the country's big current account surplus. More important from a domestic standpoint, it will improve living conditions in Japan, which fall short of the physical environment of most other industrial countries.

While Japan can afford to expend Y430 trillion on social and economic infrastructure over the next decade, the government has to weigh annual outlays against projected yearly budget revenues and the potential impact of stepped-up public investment on inflation and the current labor shortage. Coordination among the many government ministries and agencies involved in public works and cooperation between the central government and local authorities will be necessary to make the best use of the extra money earmarked to improve the quality of life in Japan.

Public Investment and the SII Talks

Japan's towering 1987 current account surplus of $87 billion had been trimmed by more than a third by last year, but even with another big cut this year to perhaps $40 billion and maybe less, the difference between the country's exports and imports of goods and services (including investment income) remains huge. The reason is simple, at least for economists: savings in Japan, whether by individuals, businesses or the government, far exceed private and public investment at home. Reducing this difference, primarily by persuading Tokyo to spend more money on Japan's inadequate social infrastructure -- housing, parks, sewer systems and the like, was one of Washington's six major objectives in the Structural Impediments Initiative talks. The yearlong SII exercise, which was completed in late June, aimed at addressing the underlying causes of the enormous U.S.-Japan trade imbalance. (For a summary of the final SII report, see JEI Report No. 24B, June 22, 1990.) While bridging Japan's savings-investment gap might have various implications for the United States -- some of them less than positive (see JEI Report No. 14B, April 6, 1990), the proposed benefits to the average Japanese citizen of higher government expenditures for social infrastructure helped sell the SII package there.

Japan's high savings rate stems primarily from the robust efforts of individuals. The money put aside by Japanese equaled anywhere from 13.7 percent of nominal gross national product (FY 1987 and FY 1988) to 17.1 percent (FY 1980), as measured by the Economic Planning Agency (see Table 1). The government also became an increasingly big saver in the second half of the 1980s, primarily because of the buildup of the social security trust fund. On the investment side, the corporate sector's normally healthy spending on plant and equipment (15 to 17 percent of GNP) picked up some steam in the last years of the 1980s, hitting 19.6 percent in FY 1988, for example. Both individual and

Table 1: Japan's Savings-Investment Balance, FY 1980-FY 1988

(as percent of GNP)

	FY 1980	FY 1981	FY 1982	FY 1983	FY 1984	FY 1985	FY 1986	FY 1987	FY 1988
Private Sector									
Savings	28.7%	27.8%	26.4%	27.1%	26.4%	26.7%	26.8%	24.8%	25.0%
Household	17.1	17.0	15.6	15.7	15.2	15.0	14.9	13.7	13.7
Corporate	11.5	10.8	10.8	11.4	11.2	11.7	11.9	11.2	11.4
Investment	25.1	23.9	22.9	21.8	22.5	22.7	22.2	23.4	24.9
Household	7.9	7.2	7.4	6.5	6.3	5.1	5.3	5.9	5.3
Corporate	17.2	16.7	15.6	15.3	16.2	17.6	16.9	17.5	19.6
Net Balance	3.6	3.9	3.4	5.3	3.9	3.9	4.6	1.4	0.1
Government Sector									
Savings	3.1	3.3	3.3	3.4	4.0	4.9	5.4	7.2	9.0
Investment	7.1	7.0	6.7	6.3	5.8	5.6	5.7	6.2	6.1
Net Balance	-4.0	-3.7	-3.4	-3.0	-1.8	-0.8	-0.3	1.0	2.9
Domestic Savings-Investment Balance	-0.4	0.2	0.0	2.3	2.1	3.1	4.2	2.4	3.0
Current Account	-0.6	0.5	0.8	2.0	3.0	3.8	4.5	3.3	2.7

Source: Economic Planning Agency

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government investment, however, slipped in relative terms over the course of the decade. By the fiscal year ending in March 1989 business investment topped corporate savings by 8.2 percent of GNP, while consumers and the government had excess savings equivalent to 8.4 percent and 2.9 percent of national output, respectively. As a result, Japan's domestic savings-investment balance, which theoretically parallels its current account surplus, was 3 percent of GNP.

The Japanese government acknowledged in the SII talks that a reduction in the imbalance between domestic savings and investment in Japan is important to following through on its commitment to lower the nation's current account surplus. The Japanese SII team also recognized that Japan still lags behind the United States and many other industrialized countries in certain areas of social and economic infrastructure despite considerable public-sector investment over the 1970s and 1980s. Nevertheless, Tokyo rejected out-of-hand an early U.S. proposal to earmark the equivalent of 10 percent of Japan's GNP for public works spending during the 1990s. The same fate befell Washington's initial fallback suggestion of Y500 trillion ($3.7 trillion at Y135=$1.00) in expenditures over the next decade.

Shaping Japan's position were concerns, particularly in the Ministry of Finance, about the inflationary impact of a big jump in public investment and how this increase would be financed. After watching the outstanding public debt swell to a staggering Y162 trillion ($1.2 trillion) during the second half of the 1970s and the 1980s and interest payments soar accordingly, the government finally had achieved its long-term goal in the general account budget for FY 1990 of eliminating the use of deficit-financing bonds. While Tokyo was prepared to increase public works spending in the 1990s, MOF officials worried that boosting public investment considerably above the estimated Y263 trillion ($2 trillion) spent between FY 1981 and the current fiscal year might jeopardize the expected critical turnaround in the government's finances.

In March 1990, moreover, an advisory council to the Finance Ministry had recommended further efforts to shrink Tokyo's debt albatross down to size, including: reducing issues of bonds -- expected to consist solely of what are known as construction bonds -- to less than 5 percent of general account revenues by FY 1995 and redeeming outstanding deficit-financing bonds as soon as possible to cut interest payments. In essence, the MOF advisory panel suggested funding an increased portion of public works spending out of general tax revenues rather than through bond issues (see JEI Report No. 12B, March 23, 1990).

In the end, though, Tokyo was forced to put aside its worries about the budgetary and inflationary impacts of a jump in infrastructure spending because public investment, while just one of six U.S.-identified problems on the SII agenda, had become the make-or-break issue. After considerable give-and-take between the two governments in late June, Japan made a final proposal to earmark Y430 trillion ($3.2 trillion) for public investment over the FY 1991-FY 2000 period. That offer was accepted by the United States, in part because planned government outlays will be accompanied by Y25 trillion ($185.2 billion) or so in expenditures by such ex-public corporations as Nippon Telegraph and Telephone Corp. and Japan Railway Group. (Capital spending by NTT and the JR Group -- which totaled about Y24 trillion or $177.8 billion during the 1980s -- were included under government fixed investment in the GNP statistics until these organizations were "privatized" in the mid-1980s. Now their business investment shows up under private fixed nonresidential investment.)

About 60 percent or Y258 trillion ($1.9 trillion) of projected public investment during the April 1991-March 2001 period will be channeled into projects that directly improve the quality of life in Japan, up from 50 percent-plus in the government's FY 1981-FY 1990 plan. This includes outlays for housing, water supplies, sewers, waste disposal, parks and other green spaces, local roads and subways. But expenditures for these and other forms of social overhead capital, while increasing significantly, will be backloaded in the coming 10-year period, thereby slowing the adjustment of Japan's savings-investment imbalance. Moreover, Tokyo underscored its repeated message during the SII discussions about the need for spending flexibility on a year-to-year basis by noting in the final SII report that the state of the economy would be weighed in deciding how much to allocate each year for public investment.

Japan's Social Infrastructure

Most Japanese are aware that the country's social infrastructure is inferior to that of other industrialized countries, and their reaction to the government's decision to increase public investment in the 1990s has been favorable. Although Japan ranks as the world's second-largest economic power and has one of its highest per-capita incomes, many Japanese do not feel that the quality of their life has improved in line with their growing affluence (see JEI Report No. 31B, August 10, 1990).

In terms of consumer goods the average Japanese owns as many cars and appliances as Americans or Europeans do (see Table 2). In 1989, for example, 76 percent of all Japanese families owned cars, 64 percent had microwave ovens, 63 percent had air conditioners, 63 percent had videocassette recorders and almost all had color television sets, refrigerators and telephones. Newer products like compact disk players and personal computers also are found in many Japanese homes.

Table 2: Cross-Country Comparison of Car and Telephone Ownership

(per 100 people)

	Cars*	Telephone Lines**
Japan	40	40
United States	72	48
Great Britain	41	42
West Germany	49	45
France	44	44

*1987 survey by the Japan Automobile Manufacturers Association.
**1988 survey by American Telephone & Telegraph Co.

Housing in Japan and the many other things that make up social infrastructure, however, generally are inferior to those in the United States and Europe. Table 3, an international housing comparison, indicates that among the five major industrialized countries, Japan has the lowest number of houses relative to its population and, along with France, the highest number of people

Table 3: International Housing Comparision

	Number of Houses per 1,000 People	Average Number of Rooms	Average Number of People per Room	Average Floor Space (square meters)	Housing Investment/ GNP Ratio
United States	419 (1987)	5.3 (1985)	0.4 (1985)	148.1 (1987)	5.2 (1987)
Great Britain	399 (1986)	5.0 (1981)	0.5 (1981)	-	3.7 (1987)
West Germany	448 (1986)	4.4 (1978)	0.6 (1978)	93.8 (1986)	5.1 (1987)
France	451 (1986)	3.8 (1984)	0.7 (1984)	85.5 (1984)	4.4 (1987)
Japan	342 (1988)	4.9 (1988)	0.7 (1988)	79.3 (FY 1987)	5.9 (FY 1987)

Source: Ministry of Finance

per room. To make matters worse, the average residence is smaller in Japan than in the four other countries. Moreover, in metropolitan areas, where land prices more than doubled during the last decade (see JEI Report No. 28A, July 20, 1990), housing conditions often fall short of even the poor national average. It is not hard to find families in Tokyo or Osaka who own expensive cars but cannot afford to buy houses with garages.

Similarly, public infrastructure, such as paved roads and sewage and drainage systems, has not been well-developed in Japan. As is shown in Table 4, about one-third of Japan's roads remain unpaved. While publicly supplied water mains and lines cover almost all of Japan, only two-fifths of the population was served by a municipal sewer system in the late 1980s.

Table 4: International Comparision of Public Infrastructure

	1965		1988	
Paved Roads*				
Japan	7.4%		66.6%	
United States	39.0		90.0	(1986)
Great Britain	100.0		100.0	
West Germany	65.0	(1966)	99.0	(1986)
France	79.0		92.0	
Hookup to Public Water Supply**				
Japan	53.4%		94.2%	
United States	93.0		99.3	(1977)
Great Britain	99.0	(1961)	99.2	(1985)
West Germany	91.0	(1963)	97.3	(1985)
France	79.0	(1962)	99.2	(1985)
Hookup to Public Sewer System**				
Japan	6.0%		40.0%	
United States	68.0	(1962)	73.0	(1986)
Great Britain	90.0	(1963)	95.0	(1982)
West Germany	63.0		91.0	(1983)
France	40.0	(1963)	64.0	(1983)

*In terms of a country's total road network.
**In terms of a country's total population.

Source: Ministry of Finance

Although both the central government and local authorities have invested large sums over the past 20 to 30 years to improve the road network and other types of social infrastructure, Japan still lags behind the United States and Europe. Projects to construct new highways and airports and provide additional public transportation for commuters often have been held up because the people or the companies that own needed land refuse to sell or demand too high a price. The same factors help explain why a review of public parks or green spaces in some of the world's major metropolitan areas shows the average Tokyo resident having only 23.7 square feet, while New Yorkers enjoy 206.4 square feet each, Londoners 326.8 square feet and citizens of Bonn, 402.1 square feet. Japanese city dwellers have to exercise patience whenever they venture out into the crowds to enjoy the weekend.

Y430 Trillion and the Current Account Imbalance

As noted, public investment in the 10 years through March 1991 is expected to total Y263 trillion ($2 trillion). That figure covers government fixed investment -- the number that shows up in Japan's GNP statistics -- plus the cost of land and any compensation paid to landowners to buy their property. Government fixed investment is projected at Y224 trillion ($1.7 trillion). Using these figures (see Table 5), the portion of public investment used to buy land in the FY 1981-FY 1990 period is about 15 percent. If that ratio remains constant in the coming 10-year period, the planned Y430 trillion ($3.2 trillion) in public investment will translate into fixed investment of roughly Y366 trillion ($2.7 trillion).

In terms of narrowing Japan's savings-investment gap and, by extension, its external imbalance, the Y366 trillion ($2.7 trillion) figure may have the most relevance since land purchases and compensation payments simply transfer wealth rather than absorb savings. Will spending of this magnitude over the coming decade do the job? Not according to Washington's calculations. U.S. economic policymakers had argued during the SII talks that anything less than Y500 trillion ($3.7 trillion) or its estimated counterpart, 10 percent of GNP, would do little to rectify Japan's savings-investment imbalance. Add in the likelihood that land costs, which continue to rise across Japan, will absorb more than 15 percent of the planned Y430 trillion ($3.2 trillion) in public investment and the chances for adjustment in the current account imbalance become more remote.

Martin Feldstein, former head of the president's Council of Economic Advisers, has argued that setting a high numerical target for Japan's public investment in the hope that stepped-up outlays will produce an adjustment in the current account imbalance is misguided. The planned Y430 trillion ($3.2 trillion) in public investment could fall victim to inflation, primarily rising land prices, or a robust economy and end up having a negligible impact on the surplus. Thus, he said, Japan's real interest in boosting public investment should be to improve the quality of life. That line of reasoning strikes a responsive chord among Japanese economic policy planners, who believe the link between bridging Japan's savings-investment gap and reducing the country's external imbalance is weaker than their American counterparts say.

Y430 Trillion and the Budget

Whether government fixed investment reaches 7.2 percent of GNP in FY 2000 as the Economic Planning Agency projects, the ratio is certain to be higher than the 6.3 percent estimated for the current fiscal year. That figure, while below the government fixed investment/GNP statistic for every April-March period in the 1980s, will continue to top the comparable numbers for Japan's major competitors. In 1987, for example, Japan plowed three times as much into government fixed investment as the United States did and more than two times what the West German government spent (see Table 6).

Table 5: Estimate of Japan's Public Investment

(in trillions of yen)

Fiscal Year	Public Investment (A)[1]	Government Fixed Investment (B)	Nominal GNP (C)	A/C	B/C
		Actual			
1981	Y27.5	Y24.0	Y259.7	10.6%	9.2%
1989	29.4	25.6	398.2	7.3	6.4
1990	30.2	26.3	417.2	7.2	6.3
1981-90	263.0[2]	224.0[3]			
1981-90 Average Growth Rate	1.9%	1.9%	4.9%		
		Projected			
1991	Y32.1	Y27.3	Y437.0	7.3%	6.2%
2000	55.6	47.3	663.6	8.4	7.2
1991-2000	430.0[2]	366.0[4]			
1991-2000 Average Growth Rate	6.3%	6.3%	4.75%[5]		

[1] Public investment (A) = government fixed investment (B) + cost of land purchased and compensation fee.

[2] Amount of public investment cited by the Japanese government in the final report on the Structural Impediments Initiative talks.

[3] Calculated from the national income statistics.

[4] Assuming the ratio of (A) to (B) during the 1980s (1.15:1.0) remains unchanged, government fixed investment from FY 1991 through FY 2000 is estimated at Y366 trillion.

[5] Projection contained in the government's Five-Year Economic Management Plan (1988-92).

Source: Ministry of Finance and Economic Planning Agency

Although Tokyo's planned infrastructure outlays over the next 10 years will remain high by international standards, the promised Y430 trillion ($3.2 trillion) in spending would not appear to place too much strain on Japan, given its high savings rate and recent expenditure levels. The big question now confronting the administration of Prime Minister Toshiki Kaifu is how to finance a jump of nearly two-thirds in public investment. Hoping to fund the increase from general account revenue measures already in place while allowing for growth in social security programs, education and other general account expenditures is not realistic; the government simply cannot count on a high-growth

Table 6: International Comparision of Nominal Fixed Investment/GNP Ratios

	Japan		United States		Great Britain		West Germany		France	
	Government	Private	Government	Private	Government	Private	Government	Private	Government	Private
1965	4.5	20.7	2.8	15.8	4.2	13.9	4.3	21.9	4.0	19.0
1970	4.6	27.3	2.5	15.0	4.7	13.7	4.6	20.9	3.6	19.7
1975	5.3	23.3	2.1	14.9	4.7	15.2	3.6	16.5	3.7	20.4
1980	6.1	21.9	1.7	17.1	2.4	15.7	3.4	19.0	3.1	19.8
1985	4.8	21.0	1.6	16.3	1.9	15.1	2.2	17.3	3.1	16.3
1987	5.3	22.3	1.6	15.8	n.a.	n.a.	2.4	16.9	3.1	16.3

Note: The figures for government fixed investment do not include outlays by public corporations. If this spending were included in the Japanese data, for example, the ratios would be 8.8 in 1965, 8.2 in 1970, 9.2 in 1975, 9.6 in 1980, 6.7 in 1985 and 7.0 in 1987.

Source: Ministry of Finance

economy swelling tax payments and revenues from other sources every year. Alternative sources of financing are necessary.

Raising taxes, by either hiking the rates of existing levies and/or introducing new ones, and floating more construction bonds are the obvious options. But these choices lead to the question of which generation should shoulder the burden of boosting public investment' current taxpayers or future taxpayers? Since at least part of what the government invests in infrastructure in the 1990s will benefit future generations, larger amounts of construction bonds are economically acceptable on equity grounds. As noted, though, the Ministry of Finance is loathe to increase government borrowing just when 14 years of deficit-financing have ended. Moreover, raising taxes would seem to be out of the question for the foreseeable future given the continuing debate in Japan over the consumption tax implemented in April 1989.

A much-used funding source for public investment in Japan is the Fiscal Investment and Loan Program, a capital budget financed from postal savings, the government's various pension and life insurance trust funds and borrowing. Through the FILP budget Tokyo provides long-term loans for public works projects undertaken by local governments or public organizations like Water Resources Development Corp. and Japan Highway Public Corp. Most of Japan's transportation infrastructure -- highways, bridges, the nationwide rail system, harbors and airports -- has been constructed with FILP monies. Government policy planners anticipate that a considerable part of public investment in the FY 1991-FY 2000 period will be financed through the FILP budget. But with Japanese interest rates now at their highest levels in 10 years, local governments and public organizations will have a hard time borrowing significantly more money than they did in the 1980s.

The sliding price of NTT stock over the last two years adds another complication to the public investment financing question. The government had planned to use part of the proceeds from the sale of its NTT shares to the public to provide interest-free loans through the FILP budget for public works projects. The 1986 and 1987 auctions produced the expected financial results, but NTT's weakening share price forced the government to scale back its offering in 1988 and to cancel the sale altogether in 1989. Plans for an auction this year -- when the last government-owned shares to be offered to the public originally were scheduled to be sold -- are on hold since NTT stock prices remain depressed.

Given these considerations the increase in public investment during the 1990s is likely to be funded by a combination of additional general account borrowing, a new or expanded land-related tax (see JEI Report No. 28A, July 20, 1990) and higher spending through the FILP budget, with construction bonds providing most of the extra financing. The government has some time to figure out the best mix. Determined to retain public works spending as a major countercyclical policy tool, Japan's SII team made no commitment to front-load outlays in the first half of the 1990s or even to raise spending each year by the 6.3 percent average rate needed to boost public investment to Y430 trillion ($3.2 trillion) for the FY 1991-FY 2000 period. All Tokyo told Washington was that it expected to invest approximately Y182 trillion ($1.4 trillion) in infrastructure by the midpoint of the 10-year period.

Finding the money to expand public investment in FY 1991 should not be too difficult because the rise probably will be limited to keep the economy, which is expected to continue growing at a moderate pace, from overheating. But holding the growth in public investment below 6.3 percent will require some hard decisions by the Ministry of Finance, at least on that part of spending financed through the general account budget.

When the ceiling for FY 1991 general account budget requests was set this past summer (see JEI Report No. 30B, August 3, 1990), the cabinet of Prime Minister Kaifu incorporated two special measures to increase public investment. First, it added Y200 billion ($1.5 billion) for public works projects to the money the central government otherwise would transfer to local jurisdictions. Second but more importantly, it established a Y200 billion ($1.5 billion) fund for projects to improve the quality of life. The availability of this extra funding produced a flood of proposals from 13 ministries and agencies anxious to strengthen their bureaucratic clout. As Table 7 indicates, requests add up to more than five times the Y200 billion ($1.5 billion) available.

Table 7: FY 1991 Budget Requests for "Life-Improvement" Expenditures

Ministry	Amount (billion yen)	Use
Ministry of Construction	Y200	Sewage/drainage, housing
Ministry of Agriculture	190	Sewage/drainage in rural areas
Ministry of Transportation	173	Subways, rail system
Ministry of International Trade and Industry	159	Shopping areas (incl. parks)
Ministry of Health and Welfare	131	Water supply, garbage disposal
Ministry of Education	122	Lifetime educational promotion centers
Ministry of Posts and Telecommunications	102	Underground telecommunications lines
Other Ministries and Agencies	44	
Total	1,121	

Source: Yomiuri Shimbun, August 30, 1990.

Cooperation Among Authorities

Efficient development of social infrastructure in any country requires extensive coordination among the many government organizations funding projects that fall under this heading. Plans for new housing, for example, should take into account the need for transportation systems, water and sewage services, schools, shopping centers and parks. But this type of coordination is difficult in Japan where more than a dozen ministries and agencies are involved in public works projects. The division of responsibilities between the central government and local governments adds another complication. Municipal authorities handle many of the country's public works projects, but the bureaucracy in Tokyo generally controls the funding as well as part of the related approval process. As recently as five years ago, for example, a city needed permission from the Ministry of Transportation to move a bus stop. These two problems have prompted many analysts to argue that efficient use of the Y430 trillion ($3.2 trillion) for public investment over the next 10 years depends on better coordination among involved central government organizations and the delegation of more power to local governments.

Changes also are necessary at the local government level, these analysts say. High on their lists are mergers among municipal districts and/or neighboring cities or towns. There are 47 prefectures, 656 cities and 2,590 towns and villages in Japan. Most of the municipal districts are too small to implement public works programs effectively. Without tie-ups, formal or informal, among local government units, transjurisdictional construction projects, such as commuter train lines and sewage/drainage systems, can get bogged down in disputes.

Furthermore, since public investment affects so many other parts of the economy, Tokyo is being urged to develop a comprehensive policy that addresses labor supplies, land prices, taxes and similar issues. If public works projects involve land purchases, for example, the government should have some means at its disposal to prevent a run-up in prices; otherwise, money that could be used for construction goes to landowners. Similarly, if labor markets are tight when public investment is on the upswing, the government must be ready to consider ways to counter the shortage of workers. A comprehensive plan also would address rural/urban migration since additional housing and transportation links in metropolitan areas never will alleviate the crowded conditions unless some way is found to stem the population movement away from rural areas.

The issue of social overhead capital in Japan obviously goes beyond the relationship between public investment and the country's current account imbalance since it highlights many important socioeconomic problems. Tackling these problems is reason enough to boost public investment.

For further information, contact Tadashi Saito.

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The views expressed in this report are those of the author and do not necessarily represent those of the Japan Economic Institute.

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JAPAN · ECONOMIC · INSTITUTE

JEI REPORT

A Two-Part Report: A and B

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IN THIS ISSUE:

Tokyo Tries To Demonstrate Burdensharing Commitment 1

Final Budget Agreement Likely To Affect Foreign-Owned U.S. Subsidiaries 3

TSE Bottoms Out? 4

U.S.-Japan Trade: January-June 1990 7

Tokyo Tries To Demonstrate Burdensharing Commitment

Recent calls by allies for Japan to follow through on its $4 billion commitment to the Persian Gulf peacekeeping effort have struck an attentive audience in Tokyo. Prime Minister Toshiki Kaifu announced September 27 the outlines of Japan's proposed United Nations Peace Cooperation Law, which would enable Tokyo to dispatch nonmilitary personnel to international crises in support of U.N.-sponsored peacekeeping initiatives (see JEI Report No. 38B, October 5, 1990). Coming on the heels of this, a government source leaked to the Japanese press October 1 a plan to introduce legislation that would enable Japan to shoulder more of the costs of maintaining U.S. forces on its soil.

In meetings with American defense policymakers that same week Yukio Okamoto, an official with the Foreign Ministry's North America division, elaborated further on Japan's Middle East-directed aid effort, indicating that approximately $2 billion of the total assistance pledged for logistical support will be used to purchase U.S.-made equipment for the multilateral forces as well as to help defray the costs of transporting American troops and equipment to this war-threatened region. (The other $2 billion is earmarked for helping Turkey, Egypt, Jordan and other frontline Middle East countries that have been hurt economically by the trade embargo against Iraq.)

Japan Economic Institute 1000 Connecticut Avenue, N.W., Washington, D.C. 20036 202·296·5633

U.S. Exports to Japan by End-Use Category

(in millions of dollars, f.a.s. value)

	January-June 1989	January-June 1990	Percent Change
Total Exports to Japan	$21,845.3	$23,512.5	7.6%
Food, Feed and Beverages	4,248.7	4,191.3	-1.4
Wheat	220.6	214.8	-2.6
Corn	848.2	835.6	-1.5
Sorghum, Barley and Oats	148.9	161.8	8.7
Other Animal Feeds	156.7	133.2	-15.0
Soybeans	512.2	444.0	-13.3
Meat and Meat Products	839.9	787.0	-6.3
Fish and Fish Products	659.4	736.5	11.7
Fruits and Fruit Products	354.7	325.4	-8.3
Vegetables and Vegetable Products	149.5	154.6	3.4
Nuts and Nut Products	55.7	64.6	16.0
Bakery and Confectionery Products	41.2	37.2	-9.7
Wine	30.1	43.8	45.5
Other Alcoholic Beverages	40.1	66.8	66.6
Industrial Supplies and Materials	7,905.1	7,379.8	-6.6
Raw Cotton	277.3	323.0	16.5
Unmanufactured Tobacco	204.9	169.5	-17.3
Hides and Skins (incl. furskins)	169.3	221.3	30.7
Leather and Fur	40.3	73.1	81.4
Metallurgical-Grade Coal	290.7	236.5	-18.6
Other Coal	201.9	217.5	7.7
Fuel Oil	89.0	72.2	-18.9
Other Petroleum Products	273.7	161.2	-41.1
Natural Gas	72.2	71.7	-0.7
Nuclear Fuel Materials and Fuels	559.9	286.7	-48.8
Logs, Lumber, Plywood and Veneers	1,199.0	1,264.1	5.4
Manufactured Wood Supplies	39.1	50.6	29.4
Paper Base Stocks	490.6	380.8	-22.4
Newsprint and Other Paper Products	250.7	244.8	-2.4
Cotton and Other Natural Fibers, Yarn and Fabric	30.4	24.4	-19.7
Synthetic Fibers, Yarn and Fabric	49.4	54.9	11.1
Synthetic Rubber	26.1	25.1	-3.8
Plastic Materials	222.0	216.6	-2.4
Fertilizers, Pesticides and Insecticides	134.5	136.3	1.3
Industrial Inorganic Chemicals	149.0	125.6	-15.7
Industrial Organic Chemicals	551.8	443.0	-19.7
Iron Ore, Steel Scrap and Ferroalloys	71.2	61.5	-13.6
Steel Slabs, Bars, Wire Rods, Plates and Sheets	105.0	83.0	-2.1
Steel Strip, Wire, Shapes, Pipes, Tubes and Fasteners	88.4	40.5	-54.2
Aluminum	663.2	643.1	-3.0
Copper	197.8	230.2	16.4
Nonmonetary Gold	71.6	15.3	-78.6
Other Precious Metals	65.2	72.8	11.7
Other Nonferrous Metals	153.5	163.0	6.2
Fabricated Metal Products	93.8	88.5	-5.7
Unmanufactured Nonmetallic Minerals	59.0	58.5	-0.8
Manufactured Mineral Supplies	139.9	163.7	17.0
Blank Audio and Video Tapes and Other Media	61.2	77.0	25.8
Capital Goods	5,651.2	6,911.5	22.3
Electric Machinery	350.8	411.5	17.3
Generators, Transformers and Accessories	50.3	93.9	86.7
Other Electric Apparatus and Parts	300.5	317.6	5.7
Nonelectric Machinery	4,612.3	5,038.3	9.2
Excavating, Paving and Construction Machinery	65.0	73.7	13.4
Nonfarm Tractors and Parts	40.6	61.7	52.0
Industrial Engines, Pumps, Compressors and Generators	114.2	151.7	32.8
Food and Tobacco Processing Machinery	40.2	36.4	-9.5
Machine Tools, Metalworking, Molding and Rolling Mill Machinery	134.2	102.6	-23.5
Textile and Sewing Machinery	35.9	35.7	-0.6
Woodworking, Glassmaking and Plastic and Rubber Molding Machinery	28.1	42.4	50.9
Pulp, Paper, Printing and Packaging Machinery	60.9	70.1	15.1
Measuring, Testing and Control Instruments	350.6	295.9	-15.6
Materials Handling Equipment	33.6	43.3	28.9
Photo and Service Industry Machinery	167.2	165.9	-0.8

	January-June 1989	January-June 1990	Percent Change
Agricultural Machinery and Equipment	$37.3	$45.1	20.9%
Computers	557.7	607.7	9.0
Computer Peripherals, Accessories and Parts	894.7	1,096.2	22.5
Semiconductors	543.2	617.3	13.6
Telecommunications Equipment	408.8	494.6	21.0
Other Office and Business Machines	103.6	73.9	-28.7
Scientific, Hospital and Medical Equipment	507.1	540.4	6.6
Transportation Equipment	688.1	1,461.8	112.4
Civilian Aircraft	203.7	846.9	315.8
Parts for Civilian Aircraft	259.1	353.8	36.5
Engines for Civilian Aircraft	166.8	210.4	26.1
Marine Engines and Parts	35.9	33.4	-7.0
Automotive Vehicles, Parts and Engines	535.6	816.8	52.5
Cars	236.4	419.8	77.6
Trucks, Buses and Special Vehicles	45.1	58.5	29.7
Automotive Tires and Tubes	88.3	86.5	-2.0
Automotive Parts and Accessories (incl. engines)	165.6	252.1	52.2
Consumer Goods	2,753.0	3,344.0	21.5
Manufactured Consumer Nondurables	1,174.1	1,320.9	12.5
Textile Apparel, Footwear and Household Goods	82.9	117.6	41.9
Nontextile Apparel, Footwear and Household Goods	52.8	45.9	-13.1
Pharmaceutical Preparations	463.8	424.4	-8.5
Printed Material	61.9	71.5	15.5
Toiletries and Cosmetics	34.4	37.2	8.1
Cigarettes and Other Tobacco Manufactures	390.8	511.1	30.8
Manufactured Consumer Durables	1,458.9	1,871.3	28.3
Furniture	21.9	26.9	22.8
Cookware, Cutlery, House and Garden Wares and Tools	25.9	25.3	-2.3
Household and Kitchen Appliances	40.3	45.0	11.7
Floor Coverings	29.1	25.7	-11.7
Pleasure Boats and Motors	53.9	97.3	80.5
Toys, Sporting Goods, Bicycles and Motorcycles	210.1	245.9	17.0
Musical Instruments and Photographic and Optical Equipment	48.6	46.8	-3.7
Television Sets and Other Video Equipment	36.9	27.0	-26.8
Radios, Stereo Equipment and Other Audio Equipment	29.5	34.8	18.0
Records, Tapes and Disks	95.1	127.3	33.9
Jewelry and Watches	62.6	111.5	78.1
Artwork and Antiques	683.0	924.5	35.4
Unmanufactured Consumer Goods	120.0	151.8	26.5
Gemstones	116.8	147.6	26.4
Other Exports	751.7	869.1	15.6

Source: Department of Commerce, Bureau of Economic Analysis

U.S. Imports from Japan by End-Use Category

(in millions of dollars, Customs value)

	January-June 1989	January-June 1990	Percent Change
Total Imports from Japan	$46,263.6	$43,096.1	-6.8%
Food, Feed and Beverages	165.1	163.1	-1.2
Fish and Fish Products	84.8	79.9	-5.8
Industrial Supplies and Materials	4,312.9	4,224.2	-2.1
Cotton, Wool and Other Natural Fibers	0.0	83.9	100.0
Cotton Fibers, Yarn and Fabric	59.2	58.4	-1.4
Synthetic Fibers, Yarn and Fabric	192.1	159.4	-1.7
Paper and Paper Products	97.4	90.5	-7.1
Plastic Materials	275.6	298.4	8.3
Industrial Inorganic Chemicals	83.5	87.9	5.3
Industrial Organic Chemicals	352.1	310.3	-11.9
Steel Slabs, Bars, Wire Rods, Plates and Sheets	833.0	735.7	-11.7
Steel Strip, Wire, Shapes, Pipes, Tubes and Fasteners	366.5	304.7	-12.9

	January-June 1989	January-June 1990	Percent Change
Fabricated Steel Products	$289.4	$287.2	-0.8%
Fabricated Nonferrous Metal Products	183.3	290.8	58.6
Blank Audio and Video Tapes and Other Media	350.7	329.3	-6.1
Capital Goods	18,392.1	17,089.6	-7.1
Electric Machinery	1,562.9	1,597.7	2.2
Generators, Transformers and Accessories	216.2	222.7	3.0
Other Electric Apparatus and Parts	1,346.7	1,375.0	2.1
Nonelectric Machinery	16,403.6	15,141.2	-7.7
Drilling and Oilfield Equipment	111.0	106.7	-3.9
Specialized Mining and Oil Processing Equipment	254.3	277.3	9.0
Excavating, Paving and Construction Machinery	227.8	276.2	21.2
Nonfarm Tractors and Parts	141.9	146.5	3.2
Industrial Engines, Pumps, Compressors and Generators	603.8	567.5	-6.0
Food and Tobacco Processing Machinery	56.5	40.7	-2.8
Machine Tools, Metalworking, Molding and Rolling Mill Machinery	1,079.5	797.0	-26.2
Textile and Sewing Machinery	290.9	218.9	-24.8
Woodworking, Glassmaking and Plastic and Rubber Molding Machinery	423.4	333.8	-21.2
Pulp, Paper, Printing and Packaging Machinery	255.0	220.6	-13.5
Measuring, Testing and Control Instruments	385.6	351.6	-8.8
Materials Handling Equipment	349.0	242.3	-30.6
Photo and Service Industry Machinery	627.6	599.2	-4.5
Agricultural Machinery and Equipment	246.0	215.9	-12.2
Computers	303.7	238.2	-21.6
Computer Peripherals, Accessories and Parts	3,679.9	4,030.1	9.5
Semiconductors	2,010.6	1,665.0	-17.2
Telecommunications Equipment	2,491.0	2,035.1	-18.3
Other Office and Business Machines	1,196.1	1,186.0	-0.8
Scientific, Hospital and Medical Equipment	559.3	623.8	11.5
Transportation Equipment	425.6	350.7	-17.6
Parts for Civilian Aircraft	196.7	217.4	10.5
Marine Engines and Parts	100.5	69.7	-30.6
Automotive Vehicles, Parts and Engines	16,944.1	15,324.9	-9.6
Cars	9,910.5	9,247.9	-6.7
Trucks, Buses and Special Vehicles	1,623.4	945.9	-41.7
Automotive Engines and Engine Parts	1,623.6	1,271.1	-21.7
Automotive Tires and Tubes	422.8	392.6	-7.1
Other Automotive Parts and Accessories	3,318.1	3,417.8	3.0
Consumer Goods	5,997.3	5,694.3	-5.1
Manufactured Consumer Nondurables	746.8	635.6	-14.9
Textile Apparel and Household Goods	113.6	67.2	-40.8
Pharmaceutical Preparations	185.8	178.9	-3.7
Printed Material	82.5	76.9	-6.8
Manufactured Consumer Durables	5,211.7	5,024.1	-3.6
Glassware and Chinaware	122.3	121.7	-0.5
Cookware, Cutlery, House and Garden Wares and Tools	93.3	83.2	-10.8
Household and Kitchen Appliances	212.7	208.0	-2.2
Motorcycles and Parts	270.0	168.5	-37.6
Pleasure Boats and Motors	114.0	83.8	-26.5
Toys and Sporting Goods (incl. bicycles)	861.8	1,167.6	35.5
Photographic and Optical Equipment	330.6	293.7	-11.2
Musical Instruments and Other Recreational Equipment	190.6	149.7	-21.5
Television Sets and Other Video Equipment	1,504.2	1,292.9	-14.0
Radios, Stereo Equipment and Other Audio Equipment	1,060.9	997.1	-6.0
Jewelry and Watches	172.9	131.9	-23.7
Artworks and Antiques	37.3	67.1	79.9
Unmanufactured Consumer Goods	38.7	34.5	-10.9
Other Imports	452.1	600.0	32.7

Source: Department of Commerce, Bureau of Economic Analysis

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The views expressed in this report are those of the authors and do not necessarily reflect those of the Japan Economic Institute.

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JEI

REPORT

A Two-Part Report: A and B

NO. 40A October 19, 1990

CORPORATE BENEFITS AS A COMPETITIVE TOOL IN JAPAN

Summary

Compensation packages enable firms to compete for the best employees; they, in turn, are expected to boost corporate efficiency and, thereby, profits. Since benefits in Japan appear more easily adjusted than standardized pay scales, they allow a degree of flexibility in remunerating employees. The government, too, has a hand in the compensation process through its ability to mandate benefits as well as design tax policies that either encourage or discourage various options.

In the past Japanese companies have favored compensation arrangements with a strong financial component. The current labor shortage has the potential to tilt employee compensation packages toward time-related benefits or other nonwage-related remuneration. Cultural and social welfare expectations play a role in the design of benefit packages, a factor that may hit foreign firms operating in Japan doubly hard as they compete for the best Japanese employees.

Overview

Mandated benefits in both Japan and the United States make up about 8 to 9 percent of average personnel costs (see Tables 1 and 2). A major difference, however, is that in Japan more benefit programs are provided. In addition to the social security, unemployment and workers' compensation insurance required by law in the United States, Japanese personnel costs reflect charges for mandated health insurance, preschool child support and handicapped employment. This is perhaps the most striking dissimilarity between benefit packages in the two countries.

Many of the voluntary offerings that companies use to lure and keep valued talents are familiar to both nations. Also similar is the tendency and ability of the largest firms to have the most variety. As seen in Table 1, the biggest Japanese firms provide slightly more of total compensation in noncash remuneration than do small enterprises. (This holds true in the United States, too.) Noncash compensation, such as insurance and payments-in-kind, may indicate only a portion of a firm's benefit package. This amount may range from 28 percent in public utility companies employing 5,000 or more workers to 11 percent in electric machinery businesses with less than 100 employees.

Adding to the difficulty of assessing benefits, however, is deciding what ranks as a benefit. Many areas of compensation in Japan come as cash supplements to the paycheck. Although these will be discussed later, they include payments for commuting, dependents, regional "hardship" and a variety of additions to "cash" earnings that do not equate with what Americans view as wages or salary. These supplements, which are distinct from bonuses and merit pay, tend to emphasize a notion of corporate (and, to a degree, government) social support.

Benefits Packages, Mandated and Voluntary

Mandated Benefits - The government provides several social welfare types of programs with the help of companies (see Table 3). Among the services requiring joint employee-employer contributions are those for health, retirement and workers' compensation insurance. Larger firms that have their own employee health insurance fund can negotiate lower employee contributions as part of the benefit package. For medium and small-sized firms the employer and the employee usually each contribute 4.2 percent (on wages up to Y710,000 or $5,259 a month at Y135=$1.00) for health insurance.

Contributions to the employee-designated social security program (as opposed to the flat-rate payments to the national program ensuring a basic social security component) currently run 7.15 percent (6.9 percent for women) from both employer and employee on wages of up to Y530,000 ($3,926) a month. (For more information on Japan's health and social security programs, see JEI Reports No. 16A, April 21, 1989, and No. 21A, May 25, 1990.) These rates are scheduled to increase for both sexes to 7.25 percent by 1994.

For unemployment insurance an employee's pay is taxed at a rate of 0.55 percent; the employer's payroll is taxed at a 0.9 percent rate.[1] The insurance provides laid-off workers with income assistance for between 90 days and a maximum of 300 days, depending on their previous length of employment and age when laid off.

Only the company is required to make contributions for workers' compensation and another category called child allowance. The charges for workers'

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[1] Michael B. Zuzik, "Statutory Benefits in Japan" (Washington, D.C.: Wyatt Co., unpublished report), September 1990.

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Table 1: Average Monthly Cost per Regular Employee by Industry and Type of Payment in Japan, 1988

Industry	Total	Cash Earnings	Payments in Kind	Severance Costs	Mandated Benefits	Voluntary Benefits	Education Costs	Recruitment Costs	Other* Costs
Average of Surveyed	Y398,115	Y333,638	Y1,870	Y16,534	Y31,330	Y11,048	Y1,521	Y1,170	Y1,004
Construction									
5,000+ Workers	662,355	529,032	17,006	34,831	54,964	21,871	3,211	354	1,087
1,000-4,999	538,721	450,163	4,540	18,893	50,379	10,803	2,065	745	1,134
300-999	455,007	382,756	1,220	13,589	41,667	11,674	1,604	1,312	1,184
100-299	352,550	300,595	339	8,341	31,466	8,526	1,629	885	770
30-99	324,741	276,136	394	3,864	32,665	9,188	1,021	758	716
Finance and Insurance									
5,000+ Workers	658,835	534,166	6,601	40,230	41,874	26,705	3,134	2,889	3,236
1,000-4,999	499,122	423,266	2,293	21,959	33,448	12,076	2,258	1,530	2,292
300-999	459,984	387,746	3,661	16,964	33,591	11,835	2,806	1,667	1,714
100-299	466,342	391,490	2,816	13,526	33,746	15,371	2,640	5,649	1,104
30-99	499,989	424,084	5,639	18,815	38,055	9,369	1,734	1,571	723
Utilities									
5,000+ Workers	643,201	463,233	5,761	84,744	45,557	31,419	9,205	196	3,085
1,000-4,999	635,178	497,556	2,243	46,088	42,866	30,750	10,371	914	4,391
300-999	524,038	427,340	5,375	33,252	39,382	12,656	3,847	317	1,867
100-299	503,085	424,981	2,241	15,381	37,761	18,461	2,522	214	1,524
30-99	438,625	363,739	377	15,486	35,693	20,519	1,491	194	1,127
Manufacturing									
5,000+ Workers	514,809	415,624	2,807	30,430	39,221	21,637	2,958	829	1,302
1,000-4,999	453,338	378,522	2,814	21,070	34,455	12,587	1,584	1,022	1,285
300-999	380,001	323,255	1,367	14,104	30,155	7,884	1,322	1,081	834
100-299	309,435	267,196	995	8,362	25,387	5,540	704	809	442
30-99	289,748	249,964	649	7,218	25,007	5,364	453	673	420
Petroleum and Coal									
5,000+ Workers	534,792	415,579	932	25,942	39,298	45,583	2,530	1,580	3,347
1,000-4,999	696,605	543,620	8,651	43,773	47,643	48,495	2,042	441	1,940
300-999	563,495	460,348	2,462	22,564	43,644	29,638	2,331	463	2,046
100-299	490,400	407,478	1,987	28,491	34,901	15,390	1,113	229	810
30-99	400,738	345,535	550	13,963	31,546	5,309	751	1,926	1,158
Plastic Products									
5,000+ Workers	636,416	518,556	11,408	27,343	46,657	32,452	--	--	--
1,000-4,999	459,039	381,935	4,876	20,300	37,808	11,010	1,702	488	920
300-999	362,091	312,898	1,066	7,879	29,713	7,577	1,066	907	984
100-299	308,245	268,493	1,057	6,108	24,630	5,860	720	1,024	353
30-99	299,443	260,580	787	4,809	24,980	5,441	533	1,622	691
Steel									
5,000+ Workers	610,558	446,895	1,632	78,684	47,437	31,521	2,078	218	2,092
1,000-4,999	483,405	398,169	2,208	28,590	39,004	12,402	1,404	534	1,093
Publishing									
5,000+ Workers	501,728	414,344	2,211	20,689	38,242	10,827	2,954	10,639	1,821
1,000-4,999	639,159	537,479	4,666	37,868	45,925	10,199	683	671	1,667

*Includes expenses for work clothing, transfers and in-house communications.

Source: Ministry of Labor, Yearbook of Labor Statistics, 1988.

Table 2: Costs in the United States per Employee per Hour Worked by Sector, 1989

(in dollars and percent)

	Wages/ Salaries	All Benefits	Paid Leave				Supplemental Pay				Pensions/Savings		Mandated Benefits			
			Vacation	Holiday	Sick	Other	Premium Pay	Nonproduction Bonuses	Shift Pay	Insurance	Pensions	Savings/ Thrift	Social Security	Federal/State Unemployment		Workers' Comp
All Sectors	$10.38 (72.7%)	$3.90 (27.3%)	$0.50 (3.5%)	$0.34 (2.4%)	$0.12 (1.1%)	$0.04	$0.17 (1.2%)	$0.12 (0.8%)	$0.05 (0.3%)	$0.85 (5.9%)	$0.34 (2.4%)	$0.08 (0.6%)	$0.84 (5.9%)	$0.03 (0.2%)	$0.11 (0.8%)	$0.27 (1.9%)
Goods-Producing*	11.90 (69.2%)	5.30 (30.8%)	0.62 (3.6%)	0.43 (2.5%)	0.10 (0.8%)	0.04	0.37 (2.2%)	0.15 (0.8%)	0.08 (0.5%)	1.28 (7.4%)	0.45 (2.6%)	0.12 (0.7%)	1.00 (5.8%)	0.03 (0.2%)	0.16 (0.9%)	0.41 (2.4%)
Manufacturing	11.71 (68.2%)	5.45 (31.8%)	0.68 (3.9%)	0.49 (2.8%)	0.12 (1.0%)	0.04	0.40 (2.3%)	0.15 (0.9%)	0.10 (0.6%)	1.40 (8.1%)	0.41 (2.4%)	0.13 (0.8%)	1.00 (5.9%)	0.03 (0.2%)	0.15 (0.9%)	0.29 (1.7%)
Nonmanufacturing	10.00 (74.3%)	3.46 (25.7%)	0.45 (3.3%)	0.30 (2.2%)	0.13 (1.2%)	0.04	0.11 (0.8%)	0.11 (0.8%)	0.03 (0.2%)	0.70 (5.2%)	0.32 (2.4%)	0.07 (0.5%)	0.79 (5.9%)	0.03 (0.2%)	0.10 (0.7%)	0.26 (1.9%)
Services**	9.77 (74.5%)	3.35 (25.5%)	0.45 (3.4%)	0.30 (2.3%)	0.13 (1.3%)	0.04	0.09 (0.7%)	0.10 (0.8%)	0.03 (0.3%)	0.68 (5.2%)	0.30 (2.3%)	0.06 (0.5%)	0.77 (5.9%)	0.03 (0.2%)	0.09 (0.7%)	0.21 (1.6%)

*Includes mining, construction and manufacturing.
**Includes transportation, communications, public utilities, wholesale trade, retail trade, finance, insurance, real estate and services.

Note: Not listed are other benefits, such as severance pay and supplemental unemployment benefits. In 1989 these accounted for 0.02 cents of the total compensation, or 0.1 percent of the total. For goods-producing and manufacturing industries the compensation was about 0.05 of the total package, or 0.3 percent.

Source: Department of Commerce, Bureau of the Census, Statistical Abstract of the United States, 1990.

Table 3: Average Monthly Cost of Mandated Benefits per Regular Employee by Selected Industry in Japan, 1988

Industry	Total	Health Insurance	Social Security	Employment Insurance	Workers' Compensation	Child Allowance	Handicapped Employment*	Obligatory Compensation
Average of Surveyed	Y31,169	Y10,831	Y14,268	Y2,916	Y2,855	Y215	Y72	Y12
Mining**	53,421	13,605	17,486	3,010	18,981	254	51	34
Utilities	44,802	18,641	19,830	4,139	1,810	303	76	3
Construction**	38,913	11,173	14,358	3,126	9,966	230	49	11
Manufacturing**	31,367	11,157	14,636	2,940	2,332	219	65	16
Steel	43,072	15,544	19,697	3,870	3,587	280	77	18
Petroleum and Coal	42,414	16,397	18,857	4,193	2,564	297	103	2
Nonferrous Metals	37,203	13,302	17,124	3,264	3,192	248	61	13
Chemicals**	37,066	13,450	17,350	3,678	2,168	252	155	13
Transportation Equipment	36,140	12,841	17,038	3,273	2,685	252	45	6
Publishing	35,774	13,016	16,520	3,628	2,293	252	55	10
Finance and Insurance	37,652	14,675	16,359	4,163	2,061	273	117	3
Transportation and Communications**	35,344	11,358	17,079	3,263	3,342	245	41	16

*Employer's payment in lieu of hiring handicapped employees as a payroll average.

**Includes separate payments for coal mining pension contributions or for seamen's insurance. Mining in 1988 had an occupational hazard severity rate of 1.86 figured by the number of working days lost divided by the cumulative hours worked times 1,000. The frequency rate was 5.57, figured as the number of deaths and injuries due to work-related accidents divided by the cumulative hours worked and multiplied by 1 million. The forestry and services industries had higher frequency rates (11.5 and 6.24, respectively) but lower severity rates of 1.29 and 0.26, respectively.

Source: Ministry of Labor, Yearbook of Labor Statistics, 1988.

Table 4: Average Monthly Cost of Voluntary Benefits* per Regular Employee by Selected Industry in Japan, 1988

Industry	Total	Company Housing	Health Services	Canteen Services	Cultural/ Recreation Facilities	Private Insurance Coverage	Workers' Compensation Supplements	Life Passages Benefits	Asset Formation Incentives	Other
Average of Surveyed	Y11,048	Y4,242	Y1,144	Y1,425	Y1,263	Y824	Y262	Y367	Y351	Y1,170
Mining	13,847	6,251	1,124	1,342	2,015	774	536	567	53	1,184
Utilities	30,289	10,442	3,728	2,227	4,660	618	81	505	6,225	1,803
Construction	11,024	3,271	308	1,298	1,106	2,194	1,229	610	140	869
Manufacturing	11,299	4,414	854	1,785	1,284	591	188	370	286	1,526
Steel	21,976	10,789	1,734	2,386	2,506	434	253	800	648	2,427
Petroleum and Coal	40,756	23,723	1,768	3,317	5,148	604	91	783	3,515	1,806
Nonferrous Metals	13,745	5,933	1,307	2,673	1,255	385	384	497	237	1,074
Chemicals	18,120	9,202	1,215	2,283	1,705	952	175	398	393	1,796
Transportation Equipment	13,799	5,510	1,503	2,788	1,282	324	170	521	358	1,343
Publishing	9,307	1,909	568	1,683	1,233	1,553	308	597	103	1,352
Finance and Insurance	19,259	9,690	619	1,284	1,640	2,704	203	397	1,035	1,688
Transportation and Communications	14,404	4,798	4,717	1,500	1,449	331	194	349	50	1,015

*Includes cost of staffing facilities provided for employee benefits (for example, recreation facilities) as well as depreciation and maintenance of the physical structures but excludes interest costs for funds borrowed to provide the facilities.

Source: Ministry of Labor, Yearbook of Labor Statistics, 1988.

compensation benefits range from 0.5 percent of the total payroll to 14.9 percent, depending on the previous three years' accident rate. For example, the equivalent of an estimated 4 percent of the average monthly pay for a miner went toward workers' compensation insurance in 1988, an indication that even those industries hardest hit by accidents are not taxed at the highest possible rate.

The average cost for the child allowance -- a program that underscores the government's use of mandated benefits for welfare concerns -- is 0.09 percent of wages up to Y530,000 ($3,926) a month.[2] The purpose of this payment, according to the Social Insurance Agency, is "to contribute to stabilize the family life as well as to contribute to the healthy growth and quality development of children who will carry on the future society."[3] Payments are made as long as one of at least two dependent children or wards is under the age of five and the family has a taxable income level below a certain amount. For the first eligible child a family receives monthly payments of Y2,500 ($18.52); for any additional qualified children an eligible family receives Y5,000 ($37.04) a month. In 1988 the government figured 3.7 million children qualified. Company contributions underwrite seven-tenths of the allowance, with a national subsidy providing two-tenths and local government the remainder. In the case of self-employed workers the national government pays two-thirds and local government one-third. Public administrative units foot the bill for their own employees.

Other taxes on payroll for a social welfare-type of benefit include a handicapped employment charge and "other obligatory compensations," which may cover one-time court-ordered costs or payments that ultimately benefit employees. In the case of the handicapped obligation, the government requires companies with more than 300 employees to hire persons with disabilities; the quota is 1.6 percent of the work force. Many companies instead choose to pay what amounts to a fine of Y40,000 ($296) a month for each person not hired to fill the quota. (For example, a firm with 500 employees should have eight workers with disabilities on staff. If the firm has only two who qualify the monthly penalty for failure to meet its full quota would be Y240,000 or $1,778.) Companies that achieve or surpass the quota receive subsidies that can be used to improve facilities for persons with disabilities.

Voluntary Benefits - A variety of factors influences take-home pay as a company determines extra payments that may or may not be work-related and that may or may not be strictly termed benefits. To cite just one possibility these outlays may be how a company provides merit recognition in a pay system based primarily on seniority. The most basic determinant of job benefits is, of course, whether a person works as a full-time regular employee, on contract or part-time. Regular employees come under a company "rule of employment." Robert Ballon of Sophia University in Tokyo describes this as essentially equivalent to a collective labor agreement and notes it may be much the same as what is negotiated by a union in cases where one is present.[4]

[2] Ibid.

[3] Social Insurance Agency, Outline of Social Insurance in Japan, 1988 (Tokyo: Japan International Social Security Association, 1989), p. 93.

[4] Robert J. Ballon, Japan's Salary System (Bulletin No. 120) (Tokyo: Sophia University, 1988).

Other workers, primarily those with contracts or part-time employees (an estimated 11 to 12 percent of Japan's current work force of 64 million-plus), have fewer benefits and generally lower wages and less interesting jobs than those given regular employees. These workers actually may put in at least 35 hours a week or possibly the 46 hours required of a regular employee. Since the majority of nonregular workers is female and since nonregular workers may be among the first to be laid off in an economic downturn, some U.S. labor analysts have suggested that women provide a considerable share of Japan's labor force flexibility.[5] Even part-time workers, however, have some benefits. For example, depending on the type of contract, a nonregular worker might have retirement as well as vacation benefits spelled out. Moreover, required contributions to health care and the national social security program mean part-time workers have some basic benefits. An amendment in 1988 to the Labor Standards Act ensures that part-time employees receive at least some paid holidays.

As Tables 1, 4 and 5 indicate, the amount and the type of voluntary benefits vary widely depending on the size of a firm and the industry it is in. The industries listed in Table 1 had the highest monthly cost per regular employee in 1988. As mentioned earlier, companies with more than 5,000 workers generally offer the best compensation packages. Publishers and companies engaged in petroleum and coal refining, however, proved exceptions to this rule in 1988; in these areas firms that employed between 1,000 and 5,000 workers actually had better remuneration schemes than did those with more than 5,000 employees. Big, elite firms, which are capitalized at more than Y1 billion ($7.4 million), make up less than 10 percent of the companies registered in Japan but employ an estimated 25 to 30 percent of the work force.

The difference between what the largest firms provide on average in terms of voluntary benefits for their regular employees and what smaller firms give in the same industry is quite striking, particularly for petroleum and coal refiners, where the bigger firms pay more than nine times what small enterprises offer. Similarly, large plastics manufacturers provide nearly six times the voluntary benefits of their small counterparts. No wonder that potential recruits angle for larger businesses.

The line-up of voluntary benefits that Japanese companies provide covers a broad span. Company housing, which includes rent or mortgage subsidies as well as dormitories for single employees, is a substantial cost for many of the industries with large benefit payments but not for publishing, in which nearly half the work force is female. Although a survey by the Economic Planning Agency late last year indicated that more women are living on their own in apartments than in the past, unmarried women traditionally were expected to live with their parents. If the publishing industry retains its substantial ratio of female workers and more women continue to set up separate housekeeping, more publishers may begin offering increased housing benefits.

Of the other voluntary benefits provided by various industries, life insurance coverage in the construction field is about as attractive a benefit as it is among finance and insurance workers, although most likely for different

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[5] Robert Bednarzik and Clinton Shiells, "Labor Market Changes and Adjustments: How Do the U.S. and Japan Compare?," Monthly Labor Review, February 1989, pp. 31-42.

Table 5: Prevalence of Bonuses and Benefits in Japan per Type and Company, 1986

(in percent)

Size of Enterprise	Production-Related Incentives for: Efficiency	Output	Work-Related Bonus for Managers	Bonus for Specialists	Unusual Duty Differential	Ability Bonus	Attendance Incentive	Commute Benefit	Lifestyle-Related Benefits Family Benefit	Regional Benefit	Housing Benefit	Other	Other
Total	13.4%	5.6%	81.2%	12.1%	27.8%	40.5%	54.0%	87.8%	74.3%	16.3%	44.5%	27.6%	17.7%
1,000+ Workers	8.1	4.4	79.4	29.1	59.6	35.2	15.9	93.3	90.0	42.5	65.3	55.7	27.9
100-999	13.7	5.3	87.2	17.0	39.3	43.4	48.3	91.2	82.0	27.5	52.3	35.5	22.1
30-99	13.4	5.7	78.9	9.7	22.4	39.6	57.4	86.4	71.1	11.2	40.9	23.7	15.7

As Percentage of Employee's Average Monthly Remuneration

Size of Enterprise	Production-Related Incentives	Bonus for Managers	Bonus for Specialists	Unusual Duty Differential	Ability Bonus	Attendance Incentive	Commute Benefit	Family Benefit	Regional Benefit	Housing Benefit	Other	Other
Total	0.9%	2.6%	0.1%	0.8%	0.4%	0.6%	3.1%	2.9%	0.5%	1.4%	0.5%	0.8%
1,000+ Workers	0.5	2.4	0.1	1.0	0.1	0.2	3.0	3.7	0.6	1.4	0.3	0.6
100-999	1.2	2.8	0.1	0.8	0.5	0.8	3.4	2.5	0.4	1.6	0.6	1.0
30-99	1.5	2.8	0.1	0.5	0.7	1.3	2.7	1.6	0.3	1.3	0.6	1.1

Source: Sangyo Rodo Chosasho (Industry and Labor Research Center), Chingin-Jijo, March 5, 1989.

reasons. Voluntary benefits prevalent at large Japanese firms in general correspond to many of those provided by medium and large U.S. firms (see Table 6). Companies in both countries can be found that offer company-based pension plans, severance pay, educational benefits, in-house infirmaries and subsidized meals.

Interestingly, proponents of a federally required parental leave policy in this country often cite Japanese maternity leave insurance as evidence that the United States is behind most other industrialized countries because it has no such policy. Japanese law provides that health insurance will cover 60 percent of an insured expectant mother's standard monthly remuneration for six weeks before giving birth and a similar amount for eight weeks after delivery, minus whatever her employer might pay. However, a majority of Japanese women quit their jobs after becoming pregnant and place little demand on this part of the insurance system.

Since Japan confronts a labor shortage that the nation's low birthrate is unlikely to relieve, a growing number of firms may respond to economic pressures (and an official recommendation) and hire more women in mainstream jobs (which entail transfers as well as increased promotion opportunities). Thus, more women also may begin to take advantage of this maternity leave provision. One publishing company made headlines in May by adopting a three-year maternity leave policy. Previously, Fukutake Publishing Co., Ltd. estimated that an average of 50 women, almost 10 percent of its female staff, quit each year after marrying or prior to having a child. Rather than losing trained staff, the company chose to encourage employees to return to work within three years. Electronics companies, which also have a high percentage of female workers, implemented more generous maternity leave policies this spring.

A related U.S. push for leave to care for elderly or ill relatives is mirrored in Japan, where one labor research firm has been quoted as saying that one of three workers with elderly relatives at home quit to offer more comprehensive care.[6] An estimated 13.6 percent of Japanese companies employing more than 30 workers now offers leave to workers who want to care for elderly family members. Early in 1989, for example, Kikkoman Corp. extended to one year the six-month leave it has offered since 1978.

Other popular benefits in Japan include some lifestyle-related benefits, such as those for commuting, and culturally determined benefits, termed here as "life passages" payments, which are made to those who marry or for funerals. As shown in Table 5, commuting benefits are widely available, with 93.3 percent of firms with more than 1,000 employees offering some compensation and even 86.4 percent of the 30-person-and-over companies offering such a benefit. In 1988 those employees who took public transportation received an average additional Y8,308 ($61.54) a month for commuting expenses. Fewer companies offered subsidies to those who traveled by car; for those that did the payments were considerably less than for public transport, according to a 1988 report by the Industry and Labor Research Center, an independent group that specializes in labor matters.

[6] "Some firms allow absences for workers to tend aged," Japan Times, September 28, 1990, p. 3.

Table 6: Employee Benefits in Medium* and Large U.S. Firms, 1988

(percent of employees receiving benefit)

Selected Types of Benefits	Total Participants	Professional/ Managerial	Technical/ Clerical	Production/ Service
Leave				
Paid Vacations	98%	98%	99%	97%
Paid Sick Leave	69	90	90	47
Paid Lunch Time	11	5	6	17
Paid Maternity Leave	2	3	2	2
Paid Paternity Leave	1	2	1	1
Unpaid Maternity Leave	33	37	34	31
Unpaid Paternity Leave	16	19	17	13
Insurance				
Health	90	93	91	88
Noncontributory	51	50	46	53
Hospital and Surgical	88	91	90	86
Mental Health	88	91	90	86
Dental	60	66	62	55
Vision	32	33	33	30
In HMOs	17	20	20	14
Life	92	96	94	89
Noncontributory	80	84	83	77
Accident and Sickness	46	30	36	60
Noncontributory	37	23	29	49
Long-Term Disability	42	63	53	24
Noncontributory	33	50	42	20
Retirement and Savings				
Defined Benefit Pension	63	65	64	61
Earnings-Based	45	61	56	31
Defined Contribution Pension	45	60	55	32
Savings and Thrift	25	37	32	15
Employee Stock Ownership	2	3	3	1
Profit-Sharing	18	20	21	15
Money Purchase Pension	6	8	7	3
Other Job-Related Benefits				
Educational Assistance	70	82	79	59
Employee Discounts	52	53	56	49
In-House Infirmary	35	42	35	31
Severance Pay	42	54	51	30
Relocation Allowance	33	64	28	18
Subsidized Meals	21	28	26	15
Subsidized Commuting	5	7	7	3
Child Care	4	6	6	2
Flexible Benefit Plans	5	7	8	2
Reimbursement Accounts	12	20	17	5

*Private establishments with 100 plus employees in continental United States.

Source: Department of Labor, Employee Benefits in Medium and Large Firms, 1988.

Also prevalent among Japanese companies are family benefits, in which an employee receives extra pay depending on how many dependents he (she) has. In the United States the only help on this score comes from the government in the form of income tax deductions, which Japanese wage earners also receive; American companies that provided dependent-linked pay would be accused of discrimination. In Japan, however, companies such as Nissan Motor Co., Ltd. and Toyota Motor Corp. provide Y17,500 and Y17,000 ($129.63 and $125.93) a month, respectively, for the first dependent. Nissan allows Y4,500 ($33.33) each for the second and third dependents and Y1,000 ($7.41) for four, five and six dependents. Toyota is less generous for two and three dependents (Y3,000 each or $22.22) but has no limit and pays Y2,000 ($14.82) for each dependent beyond three. Some companies specify that the primary dependent must be a spouse; others are nonspecific, according to data from the Industry and Labor Research Center.

Less widespread but still popular are benefits for housing and recompense for job location. The housing component may include a rental subsidy, company support for home-ownership plans or a monthly payment to those whose job requires them to live separately from their families. The latter group of workers often also receive a stipend for visits home. Of the companies that offer such home visits, the Industry and Labor Research Center says, 93 percent of the larger enterprises provide round-trip tickets; 81 percent of the firms with fewer than 300 employees who enjoy such a program also offer round-trip tickets. Jobs in crowded urban areas (Tokyo and Osaka, for example) and in areas that can get extremely hot or cold also can bring compensation, depending on the company. To help employees brave the chill Hokkaido winters, for example, some firms pay the benefit in fuel oil.

Culturally related benefits are those that firms pay to regular employees who are getting married or in whose immediate family a death has occurred. The funeral cash gift is separate from the funeral grant made from insurance system funds when an insured member dies. Also eligible for classification as a culturally related benefit is a marriage consultation service, which all but one of the major corporate (keiretsu) groupings provide.[7]

While a matchmaking service probably is not a major lure to potential hirees, the company that offers above-average wages or salaries, is in a growth-industry and shows an interest in offering benefits that address evolving employee concerns (such as child care) is most likely to have the edge in attracting and keeping the best employees, particularly in Japan's current tight labor market. But with incomes in Japan now among the world's highest, unions and workers there have begun to look especially toward time-related fringe benefits.

Options for Flexibility

Demand for labor in Japan currently outpaces supply by a significant margin, a situation that makes benefit packages all the more key in hiring. Job opening-to-applicant ratios, which stood at 0.65 in 1984 averaged 1.26 in 1989, the highest level since 1973. The ratio was even higher, 3.12, for recent top male high school or college graduates. Reporting this past summer on a survey of 4,500 Japanese companies, the Economic Planning Agency said 70 percent of the respondents had been unable to fill all their openings. Their response to keeping production steady, they told EPA, was to increase overtime and reduce holidays and vacations rather than hire more part-time workers.[8]

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[7] Ritsuko Yoshida, "Getting Married the Corporate Way," Japan Quarterly, April-June 1990, pp. 171-175.

When Japanese companies suggest they will trim holidays and vacations, government officials must feel like Sisyphus. Tokyo has been struggling to get firms to reduce working hours since 1988, partly in response to other nations' concerns about the output of Japanese workers, whose 2,189 hours on the job that year topped by 200 to 500 hours those of their counterparts in other industrialized nations (see JEI Report No. 11A, March 16, 1990). Another reason for promoting more leisure time is to drive up domestic demand through increased consumption. Proposals for increasing time off the job include trimming two hours off the official 46-hour workweek and encouraging companies to give more consecutive days off. This latter idea attempts to offset the concern that corporate and peer pressure keep workers from being absent for too long, even if they have accumulated vacation days. The 1990 white paper from the Labor Ministry noted that on average workers used only 7.2 of the 15.3 paid vacation days granted by their employers in 1988. (The average of 15.3 days of vacation does not include the 14 national holidays for which workers are paid.)

Firms are required to offer a minimum of 10 paid vacation days a year to regular employees who work at least 80 percent of the scheduled work days. This amount increases by one day a year (up to 20 years) as seniority accrues. Analyst Michael Zuzik of Wyatt Co., a personnel research firm, notes, however, "A controversial feature of work time in Japan is the prevalence of voluntary uncompensated overtime performed, particularly in white collar occupations, including the failure of employees to take more than 60 percent of their legally due vacations."[9] Thus, a company's decision to reduce holidays and vacations to cope with the labor shortage has to be weighed in the context of what is legally required and what actually occurs since employees do not have to take all the vacation time provided.

A similar situation exists with overtime. As noted, the government has set 46 hours as the standard workweek and is urging firms to bring that down to 40 hours by 1992. Nonetheless, the "rule of employment" in a company sets the actual work schedule. Thus, while overtime pay legally must begin after 46 hours, that does not necessarily correspond to what a company considers to be overtime; for example, a firm could set the workweek at 44 hours. Neither does it mean that salaried employees will log in their extra hours even though those below the level of section chief are entitled to overtime. (Section chiefs and those in higher positions typically are not paid overtime but instead receive pay supplements that correspond to their position. Sophia University's Ballon notes, "In dire circumstances, when the company reduces overtime pay, it also reduces position allowances."[10]) Therefore, while industrywide overtime

[8] A.E. Cullison, "Japan's Labor Shortage Nears Critical Stage," Journal of Commerce, July 9, 1990, p. 4A.

[9] Zuzik, op. cit., p. 23.

[10] Ballon, op. cit., p. 23.

increased by a small 0.6 percent last year compared with 5.6 percent in 1988, actual overtime remains difficult to assess because of its treatment on a company-by-company basis.

A Labor Ministry survey this past May indicated that fewer hours were being required on the job, however; 60 percent of manufacturers and 64 percent of wholesalers and retailers told MOL that they had reduced work hours. This does not mean necessarily that they cut back to 46 hours a week. An early October news report noted that only 56.8 percent of the companies surveyed by MOL limited their workweek to this number as of June and, conversely, that more than two-fifths of the respondents still were requiring overtime. Moreover, data compiled by the Statistics Bureau for July indicate that the average male worker spent 50.4 hours a week on the job and women worked a 39.3-hour week for a combined figure of 45.8.

In describing Japanese corporate attitudes toward overtime, Mr. Ballon of Sophia University has said, "The first measure taken by a company getting into difficulties is to cut overtime pay, not necessarily overtime itself." This is possible since firms can, and often do, set their overtime pay rate higher than the required 25 percent premium. Mr. Ballon noted that firms often use a portion of the increase negotiated during shunto (spring wage offensive) to boost their rate of overtime pay. According to his research, overtime pay typically has added an extra 10 percent a month to a worker's earnings in the postwar period.[11] By adjusting overtime premiums companies can gain wide latitude in coping with labor shortages. Hiring new employees adds far more to personnel costs than paying existing workers an additional 25 percent or more of their hourly pay.

What the increased demand on workers does not take into account, however, are employee stress and the offset to productivity. A summer survey by the Labor Ministry touted Nichia Chemical Co., Ltd. of Tokushima prefecture as a model firm in which longer vacations improved worker efficiency. The firm, which offers 20 consecutive days off to employees in the summer, said that since its program began six years ago productivity is higher than ever.

This example would seem to suggest that the business community and the government have a common interest in expanding the number of paid vacation days. Although the costs may be high for companies in terms of paying wages or salaries and benefits for days not worked, advantages come in having a major recruiting tool in today's tight labor market and the prospect of higher productivity by new and existing employees alike. But, depending on how leave is structured, companies risk cementing a benefit into their compensation packages that could prove costly when the economy softens and the number of workers looking for jobs tops the number of openings. For that reason alone, cash-oriented compensation packages remain a popular option in corporate Japan. More time off in a culture where the salaryman's identity often stems from that of his employer (he's a "Mitsubishi" man, for example) suggests that the business world's responses to changing labor situations could loosen the company ties that some analysts have suggested are partly responsible for Japanese corporate success.

[11] Ballon, op. cit., p. 22 and p. 39.

Multinational Firms and the Company as Family

Popular studies point to the paternalistic nature of Japanese corporations under whose mantle employees expect to work in a variety of positions throughout their employment lifetime without fear of layoffs. The corporation's well-being translates into healthy returns to workers in the form of wages or salaries, bonuses and/or benefits. The Japanese company-as-family approach has been credited with the country's low turnover rate and the Japanese worker's acceptance of transfers, benefit reductions and unexpected job assignments when his (her) employer is caught in an economic downturn and tries to adjust by reassignments or diversification rather than layoffs. Foreign-based corporations operating in Japan have assailed this attitude for complicating their ability to hire top-notch personnel since these potential employees worry that a nondomestic company will not be as committed as a domestic firm would be to retaining staff.

Adding to the problems of foreign-based firms in Japan is the necessity, at least in the case of U.S. firms, of conforming to laws in their home countries as well as to Japanese laws. Thus, headquarters could be expected to nix any benefit packages that would be considered discriminatory at home. Extra compensation for dependents, for example, would violate the equal-pay-for-equal-work standard in the United States. Yet this is a popular benefit in Japan.

In both countries, however, tax policy appears to favor companies giving -- and employees taking -- benefits in noncash form, particularly in the case of pension contributions in Japan. Tax-qualified pension plans in that country allow employers to contribute money to privately operated pension funds for the benefit of their employees; these funds are taxed at a low rate (see JEI Report No. 21A, May 25, 1990). Also, very small companies can get a limited tax deduction for money they claim will be available for pension payouts; while listed as such for accounting purposes, the company can continue to use these funds until an employee retires.

At An Advantage Internationally?

As a competitive tool compensation packages -- inclusive of wages and salaries, bonuses and benefits -- primarily work within a country to help firms attract the best employees. Benefit programs also address a variety of health and welfare issues important to workers. Moreover, they can improve morale, thus boosting productivity. But compensation packages also have an international competitive angle for countries like Japan and the United States that are major exporters since they shape an important component of total production costs.

In economic growth periods benefits flourish in both Japan and the United States as an attractive way to compensate employees. What concerns some analysts, however, is whether an economic slowdown, which often results in layoffs or furloughs in the United States and thus reduced personnel expenses, could corner Japanese companies into continued high personnel costs since these firms are reluctant to lay off or furlough regular employees except as a last resort.

Given this aversion and the low percentage of part-time and contract workers in the work force -- the people most likely to be laid off, Japanese employers usually turn to benefits for the flexibility they need to weather economic storms. Although changes can be made in basic wages and salaries as well as bonuses if employee representatives agree to revise a company's "rule of employment," job-related pay differentials and fringe benefits are the most likely candidates for cutbacks in hard times. Since the company-as-family philosophy encourages employees to view the firm's welfare as synonymous with their own, corporate survival is a good incentive for allowing changes.

If such changes were to be made over the near term, basic seniority-based pay scales, which make up about 70 percent of an average employee's wages or salary, most likely would remain largely intact. Thus, a typical 39-year-old male worker who receives Y264,400 ($1,958.52) a month in scheduled pay could expect similar income in the event of an economic downturn. The extra Y31,700 ($234.81) a month in merit or special allowances he usually receives might be trimmed, however. Semiannual bonuses or other additions figured on a yearly basis, which amount to Y997,800 ($7,391.11) for the 39-year-old salaryman, are among the first candidates for curtailment. With cutbacks in nonscheduled pay, this worker would earn Y3,172,800 ($23,502) a year. While an American counterpart might face a layoff, a regular Japanese worker not only would retain his or her job but still would have company-supported health and social security insurance.

At home, Japanese firms are on an equal footing as far as mandated benefit payments are concerned. This, in itself, is a major advantage vis-a-vis their international competitors, which, in the United States at least, try to attract the highest-quality labor force with various health plans and end up paying ever higher premiums as annual health costs rise at double-digit rates.

This Japanese advantage, however, could change quickly, depending on how fast Tokyo hikes the premiums for mandated benefits. Currently, the government plans by the year 2025 to boost employer-employee social security premiums to 28.9 percent of wages, although the wage ceiling, if any, has not been set. Government social security analysts have warned that even higher premiums might be needed since the rapid aging of the Japanese population has raised the likelihood that in 50 years there will be only three workers supporting every senior citizen instead of the current six-to-one ratio (see JEI Report No. 21A, May 25, 1990). Health-care costs, too, could begin climbing faster than their current annual rate of about 4 percent (see JEI Report No. 32B, August 17, 1990), thus driving up mandated premiums.

Fast-rising outlays for mandated benefits do not yield commensurate returns to employers. Competitors in countries without such mandated programs have the option of dropping coverage altogether, thereby pushing the government to step in, or shifting more of the cost onto their employees. If the United States is any example, the result may be widespread dissatisfaction with a system that covers only a part of the population and as a result is blamed for contributing to a worsening in health care and a run-up in its cost.

Although companies in Japan have only limited leeway at present to adjust the pay on which mandated benefits are based, they have far more control over expenditures for voluntary benefits. Given that a company's survival is important to its employees, strong hints of trouble from an employer may be all that is necessary for a worker to ignore offered vacation time, put in overtime without compensation or swallow a protest if bonuses are not forthcoming. Government monitoring of these areas could prevent abuses, although this depends in part on employee cooperation. In some cases, however, companies now go beyond meeting government standards or requirements (as in their rates of overtime pay) and have leeway to cut back without government censure.

What is less clear is whether the current competition for labor in Japan will drive companies to offer a plateau of benefits from which they would have difficulty retreating in an economic downturn. Although manufacturers in particular hope greater efficiency, including more automation, will offset the shrinking labor pool, high-quality employees will continue to be lured, and retained, by top-of-the-line benefit packages. A growing economy remains a Japanese worker's best insurance for a continuation of good benefits and no layoffs. While foreign competitors might hope that expanding compensation programs will lock Japanese firms into meeting higher personnel costs even in an economic crunch, the flexibility that the government and employees themselves provide companies in Japan means that adjustments most likely will continue to come in the form of reduced voluntary benefits rather than layoffs.

For more information, contact Pat Murdo.

Miky Kurihara provided research assistance.

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The view expressed in this report are those of the author and do not not necessarily represent those of the Japan Economic Institute.

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JEI REPORT

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IN THIS ISSUE:

Joint Economic Committee Examines Japan's Economic Challenge 1

Japan's Trade Surplus Dips Slightly In Third Quarter 3

Japan-EC Relations: More Ups And Downs 6

Diplomatic "Blue Book" Promotes Greater Global Engagement 8

Notes: SII Follow-Up Talks; Cray Supercomputer Contract 11

Joint Economic Committee Examines Japan's Economic Challenge

The Joint Economic Committee took a close look at U.S.-Japan economic relations in a series of hearings October 16 and 18. The centerpiece of the meetings was a soon-to-be released study initiated by the committee, Japan's Economic Challenge, which suggests the weighty U.S.-Japan trade imbalance is likely to continue into the next decade. Witnesses outlined several of the report's conclusions and cautioned committee members that Japan's growing economic power could continue to present serious challenges to the United States.

The first session concentrated on government, business and labor relations in Japan and took a close look at factors believed to be behind Japan's economic success. Dick Nanto of the Congressional Research Service, attributing much of Japan's economic power to its corporations, focused on the role of keiretsu (large corporate groups linked by cross-stock ownership and business dealings) in Japan's business environment. In the Structural Impediments Initiative talks U.S. policymakers cited keiretsu relationships and the anticompetitive business practices to which they often give rise as an underlying office of Dewey, Ballantine, Bushby, Palmer and Wood, suggested routes for both Tokyo and Washington to follow. The Japanese government should bolster the international trading system by undertaking domestic reforms to expand access to its markets and by playing a larger role in strengthening the General Agreement on Tariffs and Trade, Mr. Wolff argued. He added that Tokyo also should take more responsibility for supporting the economic growth of developing countries. Mr. Wolff's suggestions for improving U.S.-Japan relations included: employing "results-oriented" policies, conducting an ongoing review of policy problem areas and assessing the implementation of current trade agreements.

Edward Lincoln, senior fellow at the Brookings Institution, termed managed trade an undesirable but possibly necessary strategy if the United States is to counter what he described as Japan's high resistance to many imports. He added that Washington needs to implement a policy that shows where the nation is going and how it will get there, but, Mr. Lincoln added, it should not mimic Japan's industrial policy. The panelists concurred that the trade relationship between the United States and Japan may deteriorate again and probably will not improve. They also agreed, however, that it is important to work toward progress by continuing trade negotiations.

Rep. Lee Hamilton (D, Ind.), a chairman of the committee, indicated that the conclusions and the recommendations presented in the hearings and in the upcoming study on Japan's economic challenge would help determine where the issue should rank on Capitol Hill's future agenda. Given the prospects for a recession and continued constituent pressures to find both the sources of and the solutions for America's economic woes, the upcoming session of Congress is likely to keep its sights trained on Japan.

Margo Grimm

Japan's Trade Surplus Dips Slightly In Third Quarter

Given the objective of a smaller trade surplus, at least the numbers moved in the right direction. That minimalist conclusion is the best that can be said of Japan's latest customs-clearance trade statistics for the July-September quarter. For those three months Japan's trade surplus in dollar terms dropped a modest 4.8 percent compared with the year-earlier period (see Table). The yen averaged almost the same value against the dollar in both quarters; as a result, the decline in the yen-denominated surplus was on the same order of magnitude as the drop in dollar terms. However, the weakness of the Japanese currency against the dollar during the spring, when it took nearly 160 yen to equal a dollar, may have had a delayed effect in causing higher exports -- and restrained imports -- compared to what would have occurred with a stronger yen during the earlier period.

Further clouding assessments of the long-term direction of Japan's trade surplus were two unrelated and unpredictable events. The July-September figures showed only the initial effects of the run-up in oil prices linked to the Persian Gulf crisis. Compared to an average import price of $17.18 a barrel in 1989's third quarter, Japanese imports of crude during the July-September period averaged $18.13. With crude oil selling on the world spot market for nearly $30 a barrel toward the end of October, the average import price is likely to be higher in future trade figures.

Japan's Total Trade in Dollar Terms

(in millions of dollars)

	Exports (f.o.b.)	Change Over Year-Earlier Period	Imports (c.i.f.)	Change Over Year-Earlier Period	Trade Balance
1985	$175,638	3.2%	$129,539	-5.1%	$46,099
1986	209,151	19.1	126,408	-2.4	82,743
1987	229,221	9.6	149,515	18.3	79,706
1988	264,917	15.6	187,354	25.3	77,563
1989	275,175	3.9	210,847	12.5	64,328
1988: I	60,279	17.1	44,505	39.2	15,774
II	65,179	14.5	47,260	29.9	17,919
III	67,169	16.1	47,258	23.2	19,911
IV	72,291	14.8	48,331	12.9	23,960
1989: I	68,227	13.2	51,142	14.9	17,085
II	67,602	3.7	51,292	8.5	16,310
III	69,595	3.6	53,048	12.3	16,547
IV	69,751	-3.5	55,364	14.6	14,387
1990: I	66,718	-2.2	54,303	6.2	12,416
II	67,244	-0.5	53,900	5.1	13,344
III (p)	72,186	3.7	56,431	6.4	15,755

Japan's Total Trade in Yen Terms

(in billions of yen)

	Exports (f.o.b.)	Change Over Year-Earlier Period	Imports (c.i.f.)	Change Over Year-Earlier Period	Trade Balance
1985	Y41,956	4.0%	Y31,085	-3.8%	Y10,871
1986	35,290	-15.9	21,551	-30.7	13,739
1987	33,315	-5.6	21,737	0.9	11,578
1988	33,939	1.9	24,006	10.4	9,933
1989	37,823	11.4	28,979	20.7	8,844
1988: I	7,713	-3.1	5,688	14.7	2,025
II	8,163	0.1	5,918	13.6	2,246
III	8,924	4.9	6,280	11.3	2,644
IV	9,139	5.1	6,121	3.3	3,018
1989: I	8,705	12.9	6,516	14.6	2,189
II	9,222	13.0	6,997	18.2	2,225
III	9,911	11.0	7,547	20.2	2,363
IV	9,985	9.3	7,919	29.4	2,067
1990: I	9,767	12.2	7,929	21.7	1,838
II	10,451	13.3	8,383	19.8	2,067
III (p)	10,651	7.5	8,347	10.6	2,304

Japan's Trade with the United States in Dollar Terms

(in millions of dollars)

	Exports (f.o.b.)	Change Over Year-Earlier Period	Imports (c.i.f.)	Change Over Year-Earlier Period	Trade Balance
1985	$65,278	8.9%	$25,793	-4.0%	$39,485
1986	80,456	23.3	29,054	12.6	51,401
1987	83,580	3.9	31,491	8.4	52,090
1988	89,634	7.2	42,037	33.5	47,597
1989	93,189	4.0	48,246	14.8	44,943
1988: I	19,859	10.3	10,090	44.4	9,769
II	21,610	2.0	10,458	37.8	11,152
III	23,056	6.6	10,667	29.3	12,389
IV	25,109	10.3	10,821	25.0	14,288
1989: I	22,726	14.4	11,599	15.0	11,127
II	22,997	6.4	12,064	15.4	10,933
III	24,117	4.6	12,462	16.8	11,655
IV	23,347	-7.0	12,120	12.0	11,227
1990: I	21,664	-4.7	12,728	9.7	8,936
II	20,938	-9.0	12,842	6.5	8,096
III (p)	22,927	-4.9	12,708	2.0	10,219

Japan's Trade with the United States in Yen Terms

(in billions of yen)

	Exports (f.o.b.)	Change Over Year-Earlier Period	Imports (c.i.f.)	Change Over Year-Earlier Period	Trade Balance
1985	Y15,583	9.6%	Y6,213	-2.4%	Y9,369
1986	13,564	-13.0	4,918	-20.9	8,646
1987	12,148	-10.4	4,582	-6.8	7,566
1988	11,487	-5.4	5,388	17.6	6,099
1989	12,816	11.6	6,632	23.1	6,184
1988: I	2,541	-8.8	1,290	19.1	1,251
II	2,706	-10.8	1,309	20.5	1,397
III	3,063	-3.6	1,418	16.7	1,645
IV	3,177	0.9	1,371	14.4	1,806
1989: I	2,899	14.1	1,478	14.6	1,421
II	3,139	16.0	1,648	25.9	1,491
III	3,436	12.2	1,773	25.0	1,663
IV	3,342	5.2	1,733	26.4	1,609
1990: I	3,171	9.4	1,859	25.8	1,312
II	3,254	3.7	1,997	21.1	1,257
III (p)	3,382	-1.6	1,882	6.2	1,500

Another unusual event also influenced the latest trade figures. In connection with the minting of coins marking the formal accession of Japan's new emperor, gold imports in September rose 4.5-fold compared to their level a year earlier. These purchases were large enough to knock $657 million off the trade surplus for the month. Without increased gold imports and higher oil prices, Japan's trade surplus would have been flat or registered a small increase during the latest period. For Americans worried about the persistent bilateral imbalance with Japan, the news was substantially better. The dollar-denominated surplus with the United States dropped 12.3 percent to $10.2 billion.

Do the latest figures represent merely a pause in the reduction of Japan's trade surplus? Or will the gap between exports and imports start widening? Continuation of three recent trends could cause Japan's surplus to drop substantially. First, the dollar could continue to weaken. The dollar's strength this past spring already seems like ancient history; as of late October the American currency was poised to establish a new low against the yen. As the dollar weakens Japanese exports to the United States will turn sluggish, a phenomenon well-documented in recent years despite public perceptions to the contrary. The cutback will be even more rapid if the U.S. economy slows substantially; the latest U.S-Japan trade figures already may reflect weak U.S. demand to some extent. Finally, if oil remains at $30 a barrel or more, Japan's trade surplus in coming months could drop by more than 20 percent over year-earlier levels, other factors being equal.

On balance, then, the latest trade figures reflect little fundamental change from previous quarters. However, recent events suggest that big reductions in Japan's surplus could begin showing up over the next several months.

Douglas Ostrom

Japan-EC Relations: More Ups And Downs

As the tempo quickens in the European Community's move to a more united economy in 1992, Japan's relations with the EC continue to exhibit the familiar mosaic of progress in some areas but problems in others. Stimulated by the 1992 unity plan, the new economic opportunities in Eastern Europe and Tokyo's attempts to play a more active role in global political affairs, bilateral relations are being elevated to new levels.

Japanese access to the car markets of EC members has been a highly sensitive bilateral and intra-EC issue for years. While seven of the 12-member Community have no restrictions on the import of Japanese cars, five have stringent quotas. Japanese car makers, for example, have 40 percent of the Irish market, 20 percent of Belgian sales and 15 percent of the West German market but face a limit of 3 percent in France, 1.5 percent in Italy and just 1.2 percent in Spain. Beyond the question of imports from Japan, EC members have been split on how to handle the growing number of cars produced within the EC by affiliates of Japan's motor vehicle makers. Negotiating a common stance on Japanese car sales has tested the community's commitment to economic unity and to free trade principles.

After months of talks the EC proposed in late September that a five-year phaseout of quotas on Japanese car imports begin after 1992. During that transitional period Japan's share of the total EC car market would be allowed to